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ABSTRACT

A companion volume to Part I--Summary Report, this volume contains the reports of four committees. Topics are: (1) The Role and Functioning of Consumer Credit (consumer credit and social policy, consumer credit and economic growth, structure of the consumer credit market, the economics of consumer credit, credit revenues, credit costs, and a model consumer credit market); (2) Credit Criteria and Availability (credit criteria, a consideration of government roles in providing credit to low income consumers, and the overextension of credit); Consumer Credit Billing Practices (communication to the customer, customer inquiries and complaints, and posting of credits); and (4) Creditors Remedies and Collection Practices (the nature of the problem, what ethical creditors can do, credit policy and collection expenses, the delinquent debtor, the collection process, debtor grievances, A Code of Ethical Credit Grantors, and limiting factors). (WL)

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Financing the American Consumer

A Business Report on Consumer Credit

PART II Committee Reports

Report of the Sub-Council on Credit
and Related Terms of Sale of the
National Business Council for Consumer Affairs

November 1972

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Sub-Council on Credit and Related Terms of Sale

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Chairman & Chief Executive Officer
Household Finance Corporation

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Mobil Oil Corporation

Executive Secretary: **Paul T. O'Day**
Deputy Director
National Business Council for Consumer Affairs
U.S. Department of Commerce

Honorable Peter G. Peterson
Secretary of Commerce
Washington, D.C. 20230

Dear Secretary Peterson:

Attached are the reports of four committees established under the Sub-Council on Credit and Related Terms of Sale of the National Business Council for Consumer Affairs.

The committee reports have provided background for the Sub-Council's recommendations and conclusions contained in Part I of "Financing the American Consumer: A Business Report on Consumer Credit," which has been separately forwarded to you. The committee reports cover the Role and Functioning of Consumer Credit, Credit Availability, Billing Procedures, and Creditor Remedies and Collection Practices.

We believe the committees' findings will be useful to credit grantors, educators, and others interested in the consumer credit system, and in its improvement. We therefore urge that you make the reports available to the public as soon as possible.

Sincerely,

Robert E. Brooker

Robert E. Brooker,
Chairman
National Business Council for
Consumer Affairs

Arthur E. Rasmussen

Arthur E. Rasmussen,
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Collection Practices

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INTRODUCTION

On August 5, 1971, President Nixon signed Executive Order No. 11614 establishing the National Business Council for Consumer Affairs (NBCCA). The Council's membership includes over 100 business leaders and it is committed to the identification of positive action programs which will benefit consumers.

This volume contains the reports of four committees created under one of seven NBCCA Sub-Councils—the Sub-Council on Credit and Related Terms of Sale. It is a companion volume to the Summary Report of the Sub-Council, which has been published as P[illegible] I of the set.

ROLE AND FUNCTIONING OF CONSUMER CREDIT

Committee on Role and Functioning of Consumer Credit

Kenneth S. Axelson, *Chairman*
Vice President & Director, Finance & Administration, J. C. Penney Company, Inc.

Edward L. Johnson
Chairman & President
Financial Federation, Inc.

Irving S. Michelman
Executive Vice President
Budget Industries, Inc.

Mary G. Roebling
Chairman of the Board
The National State Bank

Credit is now so common that most of the families in America use it.* Notwithstanding this fact, there is apparently relatively little known about the subject. Commenting on the workings of a special Commission created by Congress to study and appraise the structure and functioning of the consumer credit market,** one member of the Senate has noted: ***

> "What has been learned to date is just how much we do not know about credit."
>
> "In short, there is almost nothing about credit that we do know for sure."

Congress is also seeking from this Commission recommendations looking toward a market structure providing for the availability of consumer credit at reasonable rates, freedom from unfair or deceptive practices, freedom from artificial or unrealistic constraints inhibiting growth, and the

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* Series for Economic Education—Truth in Lending/What It Means for Consumer Credit, Federal Reserve Bank of Philadelphia (1969).

** National Commission on Consumer Finance, Title IV, Consumer Credit Protection Act, PL 90-321, 90th Cong. S. 5, May 1968.

*** Senator Robert Taft, Jr., 92nd Cong. 1st Sess., Vol. 117, No. 125, Cong. Rec. S13113 (August 4, 1971).

informed use of consumer credit. In so doing Congress has, in effect, defined the objectives of a model consumer credit market against which the performance of today's market may be measured. The makeup of this model market, however—what it will look like—must ultimately depend on a host of broad socio-economic questions which are as yet unanswered.

Should the extension and use of consumer credit be encouraged and on what terms? What practices adversely affect the public and how can they be eliminated? What is the impact of restricting remedies on the ability to serve the market? How can consumer options be maximized? What is needed to insure the informed use of credit? To whom should credit be made available—as an economic matter, as a social matter —and by whom? What is a fair price for credit and how is that price best determined? Who should pay for the cost of credit—the user or someone else?

The challenge is to relate the defined goals of a model market to the dynamics of a complex and constantly changing consumer credit economy. In meeting this challenge we must examine the current role and functioning of consumer credit and the factors of which it is a product; we must inquire into the need for continued growth of consumer credit and into those factors which inhibit growth; we must identify the social and economic goals to be served by consumer credit in the future and the manner in which these goals can best be promoted by government and industry. To accomplish this we must understand the economics of credit extension and use, the interrelationship among rate, risk, and remedy and the impact of these factors on the structure and composition of the market. Specific issues must not be resolved on the basis of emotional appeals or political expediency. Conscious judgments must be made based on empirical evidence as to the effect of such judgments on the ability of the market to serve defined socio-economic goals.

The National Business Council for Consumer Affairs recognizes the significance of these issues and the fact that its views may be the subject of genuine debate. To the extent that this commentary stimulates reasoned discussion and contributes towards a meaningful dialogue among the participants in the consumer credit market the Council will achieve its objective. For it is only in this manner that consumers, industry, and government can arrive at a consensus with respect to the role and functioning of consumer credit as related to well defined socio-economic goals.

I Consumer Credit and Social Policy

Many commentators have tended to be inconsistent as regards the goals to be served by consumer credit and the means by which those goals may be accomplished. It has been suggested that credit should be more freely available to a broader class of persons and, inconsistently, that credit is too freely available, leading to over-extension and consumer bankruptcy. The proponents of expanded credit to broader classes of persons urge at the same time a restriction in revenues by way of reduced rates and a concomitant increase in costs resulting from various suggested limitations on creditors' remedies and requirements in connection with the extension of credit. Others desire new and more flexible, more convenient, forms of credit but ignore the costs associated with extending such credit, while all those consumers who invest their funds in the industry demand a satisfactory return on their investment.

In the final analysis the precise structure and composition of the consumer credit market, the permitted rates of charges as well as remedies and other cost related elements should properly serve explicit social and economic goals. There can be no quarrel that an ideal market should provide for the availability of consumer credit at reasonable rates, be free of unfair or deceptive practices, be free of artificial or unrealistic constraints inhibiting growth, and provide for the informed use of consumer credit. Considerations with respect to reasonable rates and reasonable remedies, however, will undoubtedly be influenced by, and vary with, a determination of those to whom credit is or should be extended, and whether government itself is to extend credit—whether credit is to be extended on a sound economic basis, to be paid for by the user, or whether credit use is to be subsidized directly or indirectly by the public or by government.

Traditionally the reconciliation of possible conflicts as between the ultimate social objectives to be served by an economic activity and the manner in which such activity may be pursued has been the province of the legislatures. In this respect certain guiding maxims can be stated. If it is deemed socially desirable to broaden the use of consumer credit through the free market system, artificial legislative restrictions and constraints must be avoided. If an increase in the availability of credit is expected, legislatures cannot reduce revenues and at the same time increase costs. To concentrate on revenues without due regard for costs or on matters which

affect costs without due regard for revenues is to ignore fundamental economic principles. If continued growth is to occur, credit grantors must be afforded a reasonable rate of return on their investment or funds will not be available for the extension of credit. If the social cost of certain procedures in connection with the extension of credit is believed to be too great, compensation for their elimination must be provided in some other form, or credit extension will cease to be a function of private enterprise.

Considering the dimension of our consumer credit economy, touching, as it does, the everyday lives of a substantial segment of the populace, it is not surprising to find, and we may rightly expect, demands for improvements in the system from consumers as well as credit grantors. Well balanced and consistent approaches to remedy inequities, resolve disputes, and deal with grievances are to the mutual interest of consumers and industry, and should be actively pursued.

Deficiencies in the marketplace are asserted by professional consumer advocates, academicians, labor representatives, and industry. They primarily relate to matters of rate, remedy, billings, collection practices, rights of privacy and the availability of credit.

Some urge that rates are too high and remedies too harsh; others contend that rates are too low and remedies insufficient to enable them to properly serve the market and permit a reasonable rate of return. There are assertions of objectionable collection practices which offend the consumer's dignity and deprive him of an opportunity to be heard. Some urge that credit is too readily available whereas others urge that credit criteria are too strict and that insufficient amounts of credit are available, particularly to lower income persons. Thus, conflicting pressures are brought to bear on an industry desirous of extending credit to those demonstrating an ability and willingness to meet their obligations, while recognizing the social and economic dangers of credit extensions to those unable to sustain the burden of debt or who are already overextended.

The proper balance between insuring the right of privacy and the need for information to facilitate the extension of credit has been brought into focus by the Fair Credit Reporting Act.[1] Also at issue is the proper method of insuring to the consumer his unchallenged right to timely billing and a prompt response to inquiries concerning his account. In the area of consumer remedies there is general recognition of the

[1] P.L. 91-508, 84 Stat. 1128.

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need for expeditious, inexpensive, and fair dispute resolving mechanisms, with the area of disagreement centering around the vehicles best suited to accomplish this goal.

Allegations of shortcomings in the workings of the marketplace, however, are not limited to consumer credit. They extend to the production, distribution, and sale of goods and services and find their expression in demands for better and safer products, more meaningful guarantees and warranties, and for adequate and accurate information necessary for rational buying decisions.[2]

In response to these grievances the National Institute for Consumer Justice, a private non-profit corporation, was created at the suggestion of the President to study existing procedures.[3] The National Business Council for Consumer Affairs is working toward the same goal. The creation of these groups is a recognition of the need for broad and serious study of consumer grievances.

It would appear that existing disputes as they relate to the consumer credit market may be broadly classified into two areas: (a) those attributable to a lack of understanding or adequate definition of the role and functioning of consumer credit and (b) those which arise out of and relate to the administration and operation of credit programs. Included in the former category are those matters relating to the price and cost of credit, appropriate rate levels and remedies, and the extent to which credit should be made available. Included in the latter category are the proper balance between the right of privacy and the need for information, timely billings, response to customer inquiries, and procedures for the collection of debts.

The consumer credit market and its responsible participants, whether they be credit grantors or consumers, will clearly benefit from the elimination of fraudulent and deceptive practices. Unethical conduct engaged in by the unscrupulous credit grantor is injurious to the fair and efficient functioning of the market. In the same category are those acts and practices which demean the consumer or deprive him of an opportunity to be heard.

More difficult is selection of the appropriate machinery for resolving disputes generated by a lack of understanding as to the economics of credit or its role and functioning. To the extent that such misunderstanding exists it is attributable

[2] Scher, "Antitrust and Consumerism: What Is It All About", 22 Case Western Reserve Law Review, 11 (1970).

[3] President Richard M. Nixon, Consumer Message, February 24, 1971.

to the failure of industry and government—of the educational system—to educate the public as to credit costs and revenues and the wise use of credit. Government must also bear the responsibility for its failure to recognize the interrelationship of rate, risk and remedy, its impact on revenues and costs, and the manner in which this affects the ability to realize overall socio-economic goals.

At the present time disputes relating to the role and functioning of consumer credit are being considered by legislative and administrative bodies on federal, state, and local levels and by courts of various jurisdictions, with frequently unpredictable and inequitable results. Such disputes, however, cannot be properly resolved unless the responsible parties are aware of and fully understand the socio-economic consequences of solutions proposed.

Problems associated with the daily administration and operation of credit programs, such as timely billing and response to customer inquiries, are not new. Rather, as ever increasing numbers of persons become participants in the consumer credit market these problems have assumed greater prominence. To blame computers for these problems simply fails to recognize that computers are programmed by human beings and that people, not computers, are responsible for responding to customer inquiries. In the public interest, industry must meet these challenges. Industry must, at the same time, find means of coping with and overcoming the impersonal relationship which has developed as a result of technological advances. In dealing with these and other consumer grievances industry should act swiftly.

For those problems not susceptible of resolution solely by further technological advances or industry efforts—for genuine disputes concerning a consumer's rights and obligations—a combination of traditional dispute resolving mechanisms and new procedures is required. Did a creditor exceed proper bounds in attempting to effect collection? Were the terms and conditions of the credit extension properly disclosed? Was the advertisement misleading? For such disputes, the goal must be to devise simple, fair procedures which can be used effectively, expeditiously, and inexpensively. In evaluating existing and proposed dispute settlement procedures against these objectives, consideration must be given to the social and economic costs of such procedures, the distribution of such costs, their deterrent effect and the best means of educating consumers as to their availability and use.

The principal formal dispute resolving mechanism to

date for matters of this kind has been litigation. Many disputes are ill-suited to resolution by litigation either by their nature or by virtue of the sums involved. This latter fact has led to demand for broadened class action availability. Such actions, however, may be used to harass legitimate businessmen with respect to matters of little social consequence or significance and for acts and practices not previously indicated to be illegal. From the consumer standpoint, they are certainly not quick methods of resolving disputes and even where successful may confer no substantial monetary benefit to the individual consumer. On the other hand, the potential for substantial fees may operate to stimulate litigation and burden the courts with unwarranted or unnecessary litigation.

Nor apparently are small claims courts the answer, at least in their present form. Small claims courts have generally been criticized as being inaccessible in terms of location and hours as well as on the grounds that the dollar limit on claims which can be heard is too low. To the extent that these problems can be resolved by reformation of current small claims courts or procedures or the creation of special consumer courts, such proposals are obviously worthy of consideration and further study.

Legislatures have traditionally served a dispute resolution function. To the extent that legislation may be predicated on relatively few instances of abuse it has the tendency to be overly broad and is frequently unnecessarily restrictive and burdensome. It is, however, in the power of the legislatures to act innovatively and create new and more effective vehicles for resolving disputes. For example, legislatures can create the special consumer courts referred to above, compel arbitration, or require conciliation and mediation.

There are currently many administrative forums, ranging from local through state to federal which purport to deal with consumer complaints. Conceptually, administrative proceedings may be one of the more efficient methods of resolving such a complaint because formal rules of law may not be applicable, the delays traditionally found in the courts can be avoided and a body of expertise with respect to consumer complaints could, over a period of time, be established. However, most agencies which purport to deal with consumer complaints are structured along the traditional lines of other governmental agencies, and would require, among other things, reshaping if they are to serve the needs of consumers and industry. Appropriate for consideration here

is the use of government agencies to obtain restitution or other redress on behalf of private parties injured by practices previously declared illegal.

Equally clear is the fact that meaningful resolution of consumer complaints will also depend on voluntary, informal settlement techniques. Efforts in this direction are found in the new Council of Better Business Bureaus, the newly established Consumer Affairs Center sponsored by the National Consumer Finance Association, and the revision or adoption of industry codes of self-regulation. Not every complaint can be handled on a formal basis. Development of effective voluntary and informal techniques may be the most workable method of providing consumer satisfaction and an opportunity to the credit grantor to preserve his goodwill.

From the standpoint of industry, neither the courts nor the legislatures have proven to be entirely satisfactory for resolving industry's grievances. There is in the courts a potential for retroactive liability with respect to practices not previously declared illegal. There is in the legislatures the potential for political opportunism in respect of issues which have broad emotional appeal, but which in fact do not advance the cause of industry or the consumer. If the public interest is truly to be served, legislators must be responsive to the wishes of consumers educated to discern the true consequences of legislation and evaluate claimed benefits as compared to the detriments. For example, will reductions in finance charges below market determined rates truly benefit the consumer? Reform in the name of consumer protection can create barriers to entry by new competitors, increase prices to the detriment of the poor, and favor large over small businesses.[4] When a legislature purports to cure an industry practice which is claimed undesirable, a price tag is attached. That price is paid in the first instance by industry, but ultimately by the consumer. Clearly, consumers as well as legislators should be aware of the price, for only then can they determine whether the cure is worth the cost.

II Consumer Credit and Economic Growth

"Credit" is defined as "an advance of purchasing power that could be used to obtain goods and services, or an advance of goods and services in exchange for a promise to pay at a later date." [5]

[4] Dam, "Consumer Protection: An Overview", 39 A.B.A. Antitrust L.J. 917 (1970); See also, Buchanan, "In Defense of Caveat Emptor", 38 U. Chi. L. Rev. 64 (1970).

"Consumer credit" consists of those amounts owed by individuals to financial institutions, retailers, and other distributors primarily for financing consumption expenditures exclusive of real estate mortgages and insurance policy loans.[6] It includes installment credit—credit scheduled to be repaid in two or more installments—and non-installment credit—single payment loans, charge accounts other than revolving credit and amounts owed to professional practitioners and service establishments.

Consumer credit existed in rudimentary form among ancient societies. Promissory notes evidencing credit transactions were used in Babylon over 4000 years ago and there was a fairly widespread use of credit in Greece and Rome.[7] Installment selling in its present form apparently had its inception in England during the latter part of the Eighteenth Century.[8]

Today, various forms of cash credit and, to a lesser extent, sales credit are found in all developed countries. Nowhere, however, has consumer credit reached the proportions or assumed the relative significance that it currently enjoys in the United States.[9]

Consumer credit outstandings approximated $137.2 billion as of the end of 1971.[10] They have increased from $5.8 billion and less than 8% of disposable personal income in 1930 to $122.5 billion and 19% of disposable personal income in 1969.[11] They represent credit extended in a variety of forms by banking institutions, consumer finance companies, sales finance companies, retailers, credit unions, and others for financing automobiles and other consumer goods, for travel, entertainment and education, for home repair and modernization, and so on.

In this growth, consumer credit has become an integral

[6] United States Department of Commerce, Office of Business Economics, *Business Statistics*, 1965, Biennial Edition, Washington, D.C. P. 92.

[7] Board of Governors of the Federal Reserve System, Statistical Release, January 1972.

[8] Sidney Homer, *A History of Interest Rates*, Rutgers University Press, New Brunswick, N.J. (1963).

[9] Edgar McAlister, *Retail Installment Credit: Growth and Legislation*, Ohio State University Bureau of Business Research, (1964).

[9] Business International Corporation, Financing Foreign Operations (June, 1971); The Oriental Economist (June 1968); *The British Economy in Figures*, Lloyds Bank (1971 ed.).

[10] Board of Governors of the Federal Reserve System, Statistical Release, January 1972.

[11] U.S. Bureau of the Census, *Historical Statistics of the United States, Colonial Times to 1957*, Tables X415-422, P. 6-9 (1960); U.S. Bureau of Census, *Statistical Abstract of the United States*, P. 317 (1969).

part of our economic fabric and has contributed substantially to the development of our economy and the high standard of living we enjoy.[12] It has provided a necessary link for the social and economic transition from a rural agrarian economy to a highly industrialized and urbanized society.[13]

As noted by the Federal Reserve Board, consumer credit has added substantially to the buying power of consumers and as such has affected both the level and structure of consumer demand for goods and services.[14] From an economic standpoint, consumer credit both enhances and advances purchasing power, thereby increasing present demand for goods and services. This increased demand, in turn, stimulates the production and distribution of goods and services thus providing greater employment opportunities and a consequent increase in demand which serves to further stimulate the process.

Moreover, in facilitating the production and distribution of goods and services on a mass scale, consumer credit makes it possible for such goods and services to be offered at a lower unit cost to the consumer. When the supply of goods and services is adequate and the consumer is active in the marketplace, vigorous competition for the consumer's favor is fostered among all classes of credit grantors. Free competition in this context results in lower prices, better services and a broader range of consumer options. It has led to the development of more flexible credit arrangements, new and more convenient forms of credit, and the ability to otherwise respond to changing conditions in a manner not feasible in a controlled economy.

In addition to its economic contribution consumer credit has had a dramatic and beneficial impact on our social structure. Thus:

> "Consumers have found that a number of benefits are derived from the use of installment credit. It gives them greater flexibility in the timing of their expenditures. High-priced goods can be acquired as opportunity or need dictates, without reference to the immediate cash position and usually sooner than would be possible if credit were not used. Many consumers use installment credit as an alternative to spending liquid assets; such

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[12] Consumer Installment Credit, Federal Reserve System, Volume 1, Part 1, P. 21 (1957); H.R. Rep. No. 1040, 90th Cong., 1st Sess. 10 (1967).

[13] Id at 21.

[14] Federal Reserve Bulletin, Developments in Consumer Credit, PP. 774-775 (June 1968).

credit users either prefer to conserve liquid assets for emergency use or welcome the discipline of monthly installment credit payments as a spur to saving.

The ready availability of installment credit has helped to compensate in a way for inequalities in buying power among consumers. It has made it easier for lower income groups to buy goods of high unit-value that might otherwise have been purchased primarily by higher income groups." [15]

The American consumer clearly enjoys a higher standard of living than his counterpart in other nations.[16] Not only does he have a wider variety of goods and services from which to choose but they may be acquired at a lower cost relative to his income. The role of consumer credit in making this possible must be recognized. If the American consumer is to continue to occupy this advantageous social and economic status, consumer credit must be encouraged to flourish.

III Structure of the Consumer Credit Market

The consumer credit market is by no means static in terms of growth, structure, or composition. The historical fragmentation linking certain types of credit and credit grantors to certain types of credit users is disappearing as a number of competitive sources offer traditional as well as new forms of credit to broader numbers and classes of persons.

An analysis of consumer credit in terms of its sources indicates that in 1970 commercial banks were the largest source of installment credit, followed by sales finance companies, and then by retailers and such other institutions as credit unions and consumer finance companies.[17] Installment credit is principally used by consumers for financing automobiles, with the second largest category being personal loans, closely followed by the financing of consumer goods other than automobiles and, far down the scale, for home repair and modernization.[18] For each of these uses except consumer goods other than automobiles, where retailers are the leading source of credit, the facilities of commercial banks are most frequently used by consumers.[19]

[15] Consumer Installment Credit, *supra* at 14-16.

[16] The United Nations Statistical Yearbook—Annuaire Statistique—1970.

[17] National Commission on Consumer Finance based on Federal Reserve Board data. (1971).

[18] Ibid.

[19] Ibid.

Significantly, the existence of vigorous competition in the consumer credit market is indicated by a dramatic shift in market shares during recent decades with respect to the four principal types of installment credit. Thus, in the financing of automobiles, commercial banks have since the 1950's gained considerably over their principal rival, sales finance companies, while credit unions and miscellaneous lenders have also shown steady gains.[20]

In the case of installment credit for goods other than automobiles, retail outlets dropped sharply in importance in the early years after World War II, but during the last twenty years their percentage share has declined only moderately. Today they account for about 45% of this part of this market. Sales finance companies have shown a net gain over the last decade but have not caught up with commercial banks whose share has begun to increase sharply again in the last few years due to the increased importance of bank credit cards.[21]

Sources of personal loans have been fairly stable over the years with commercial banks and consumer finance companies alternating for leadership, followed by credit unions and miscellaneous lenders and, lastly, sales finance companies.[22] The market for personal loans, however, is not homogenous. Certain credit institutions such as commercial banks and credit unions are lower rate lenders and usually secure the best risks, whereas consumer finance companies and sales finance companies are higher rate lenders serving primarily higher risk borrowers.

In repair and modernization loans commercial banks are by far the most important source, with credit unions and miscellaneous institutions increasing in importance and sales finance companies declining.[23]

As is evident from these data a variety of essentially competing credit services are offered by one or more of the various classes of credit grantors operating in the market. For example, automobile credit is available from banks, sales finance companies, credit unions and other sources. The purchase of other consumer goods may be financed by banks, sales finance companies or directly by retail sellers. Personal loans are available from banks, sales finance companies, consumer finance companies, credit unions, and other sources;

[20] Ibid.
[21] Ibid.
[22] Ibid.
[23] Ibid.

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repair and modernization loans from banks, credit unions, and others.

Moreover, a number of competing institutional sources will give the consumer the option of different means of financing for any single purpose. Thus, a consumer durable may be financed indirectly by a bank or sales finance company purchasing the consumer paper evidencing the debt, it may be purchased with the proceeds of a personal loan obtained from a bank, credit union, sales finance or consumer finance company or it may be financed by the retail seller directly. And, in the case of the bank, the "loan" may be made in traditional fashion or, perhaps, through the use of a bank credit card or a check guarantee or overdraft plan. Soft goods on the other hand, may be acquired with the proceeds of a personal loan, in whatever form, by means of a retail charge account, or by some other form of credit plan.

The determination of the institutional source and precise credit arrangement which will be utilized by a given consumer is the product of a complex set of legal, socio-economic and personal factors. First, of course, there are patterns of credit usage, some of which are historical in nature. Thus, certain types of consumers have generally looked to banks as the principal source for securing their financing. Such consumers, frequently in the higher income category, have also availed themselves of traditional retail charge accounts. Lower income consumers, on the other hand, have, in the past, utilized banks and sales finance companies for financing automobiles and other expensive consumer durables, where the property acquired served as adequate collateral, while looking to consumer finance companies or credit unions to meet their other credit needs. Still others, for whom credit was at one time available only from the loan shark, were brought into the legal market following legislative recognition of the need for legitimate lending sources and adequate rates.

Secondly, the selection of a financing source may depend upon such factors as geographic convenience, knowledge of alternative financing sources, availability of suitable credit arrangements for the particular product or products sought to be financed, or a host of other factors which are extremely difficult to measure such as goodwill, previous favorable credit experience, or matters of image, status, and related concepts.

In still other cases, the credit source is of secondary importance. For example, a consumer may, as a matter of simple convenience, finance where he purchases.

But further, traditional patterns of credit usage are being altered as a result of consumer demand for new credit services. There is, thus, increased use of credit for financing travel, entertainment, education, and other service expenditures previously paid for in cash. Indeed, the growth of service credit has been greater than any other type of consumer installment credit in the 1960's.[24] To meet this demand, new forms of credit services and credit extension were devised, the most important of which has been the credit card.

Credit cards have become the symbol of a convenient means of having and using credit. At the same time, credit cards have served to eliminate strict geographic, product, and other lines of demarcation as among credit grantors and consumers. Not only have there been new entrants into the credit market such as the oil company and the travel and entertainment company but competition has also been enhanced by the expanded credit services offered by existing financial institutions. Finally, the introduction of credit card plans at a time when the level of affluence of the average consumer was on the rise also contributed to the growth of what might be called convenience credit—that is, credit used as a means to facilitate payments rather than as a financing device.

However, patterns of credit usage and the structure of the consumer credit market are not exclusively the product of free market mechanisms. They are as much the product of legislation which, although varying from state to state, directly or indirectly determines who can participate in the credit market and under what circumstances.

On the direct level are those laws which prohibit particular types of institutions, such as credit unions and savings and loan associations, from offering certain kinds of credit services. There are also laws which limit the number of competitors within a given area, such as laws which require a showing that a new entrant would be of purported advantage to the community. Other laws impose limitations on the amount and maturity of a loan which can be made by a particular type of credit grantor, thereby excluding that grantor from the market for loans with higher balances or longer payout periods.

Conversely, certain classes of credit grantors enjoy tax and other benefits directly bearing upon their ability to extend credit, whereas others may enjoy competitive ad-

[24] Federal Reserve Bulletin, Developments in Consumer Credit (June 1968).

vantages based upon their unique legal status in society. Thus, credit unions may be accorded beneficial tax treatment, banking institutions may have greater access than others to low cost funds, while sales finance companies and retailers may retain an interest in the property sold.

Laws such as those discussed above reflect conscious social judgments as to the desirability of competition and the extent thereof. Such laws find a common denominator in a deliberate effort to structure the market in what is believed to be the socially preferable mode. They are purposefully designed to discourage some while encouraging others, based upon a recognition and acceptance of their consequences, and must be justified on such grounds, if at all.

To be contrasted with such laws are those laws intended to focus only on a limited aspect of credit extension but which have far reaching, albeit unintended, consequences possibly counter to an overall social policy. For example, laws which focus only on rates or on particular remedies but which ignore their impact on credit costs and revenues and the consequent ability to achieve overall social goals frequently fall in this category. Indeed, there has been increasing Congressional recognition that little is known about the intricate workings of the consumer credit market and that basic research in the field is esential to prudent lawmaking. This lack of sufficient knowledge about the workings of the consumer credit system to intelligently predict the socio-economic consequences of legislation in that field was pointed out in a recent speech in the United States Senate intended to "remind the Senate of the dangers of whimsical tinkering with an economic force as intricate as credit".[25]

> "For example, we don't know what a law that limits the price of credit would do to the supply of credit. Would such a law make credit more or less available to consumers of low and marginal income?
>
> We do not know whether a limit on the price of credit represents a real savings for our constituents or whether that consumer would wind up paying less for credit and more for the merchandise purchased.
>
> We do not know what happens to people whose applications are rejected. Do they give up their desire to buy? Or, having been rejected by legitimate credit grantors, do they seek relief by turning to unscrupulous moneylenders who operate beyond the law?

[25] Senator Robert Taft, Jr., 92nd Cong. 1st Sess. Vol. 117, No. 125, Cong. Rec. S13113 (August 4, 1971).

Various of our States have now enacted laws regulating the price of credit. What has happened in these States? The laws differ widely. How do the results compare? Again, we do not know.

In short, there is almost nothing about credit that we do know for sure. We do not even know if a law which limits the price of credit would be a spur to our competitive system or whether such a law would make chaos of the existing and viable competitive relationships among retailers, banks, small loan companies, and other credit grantors." [28]

Clearly, these questions cannot be answered without a thorough understanding of the economics of credit extension.

IV The Economics of Consumer Credit

The consumer credit market reveals a structural orthodoxy to which traditional concepts may be applied. Broadly viewed, as we narrow or widen the margin between credit costs and revenues we contract or expand the consumer credit market. Distortion of the relationship between credit costs and revenues will also have an impact on, among other things, competitive patterns, on the flow of capital, on underlying price structures, on the nature and quality of the services rendered, and ultimately on the very structure and composition of the market. For this reason it is essential that there be a thorough understanding of the relationship between credit costs and revenues and the consequences of altering that relationship as it affects the ultimate socio-economic goals to be served by consumer credit.

Both at the state and federal levels there are numerous proposals which would affect the existing credit structure; proposals which would directly or indirectly reduce revenues by reducing the permissible rates of credit charges or prescribing the balances on which such charges may be computed; proposals which will directly or indirectly increase costs by eliminating or restricting collection procedures and various creditors' remedies as well as by introducing regulatory schemes to govern virtually all credit related areas and practices.

Credit Revenues

Aside from its obvious political appeal, legislation seek-

[28] Ibid.

ing to reduce consumer credit charges is predicated on the assumption that price ceilings and, most particularly, low rates are to the benefit of the consumer.

Dr. Paul Samuelson, a Nobel Prize winner and one of the Nation's leading economists, has addressed himself to the notion that low rates benefit the consumer and found it to be without substance.

> "Finally, let me speak to the legitimate concern of consumer groups. With the best intentions in the world, some in that field cannot see the great harm which too-low ceilings do to the equitable and efficient workings of the capital markets. This has been proved time and again in connection with deposit-rate interest ceilings, mortgage ceilings and so forth. In many parts of the world progress is still hampered by adherence to medieval attitudes. We live today in an age of high market rates of interest. To keep in perpetuity low ceilings would do more harm in the next twenty years than would have been true in the twenty years following 1929. After consulting numerous other economists in the field of economics, I have satisfied myself that the proposed maximum rate schedules of the proposed Uniform Consumer Credit Code are schedules that the economy can live with—which is more than can be said for the hodgepodge that has hitherto characterized our history." [27]

The conclusions of Dr. Samuelson find ample support as they relate to both cash and sales credit. History shows that statutes prohibiting the taking of interest or regulating interest rates have almost never been effective where they ignored the realities of the money market.[28] Studies in the cash loan field indicate that price ceilings do little more than than define the size of the legal market; excluding those to whom credit may not economically be extended at the prescribed rates.[29] Still other studies suggest that in this field

[27] Statement before the Committee of the Judiciary of the General Court of Massachusetts in Support of the Uniform Consumer Credit Code, January 29, 1969.

[28] Benfield, "Money, Mortgages and Migraine—The Usury Headache", 19 Case Western Reserve Law Review, 819 (June 1968).

[29] Dr. Maurice Goudzward, "Price Ceilings and Credit Rationing", Journal of Finance, 23 (March 1968); Dr. Robert P. Shay, "State Regulation and the Provision of Small Loans", in Chapman and Shay, *The Consumer Finance Industry: Its Costs and Regulation* (Columbia University Press 1967); "An Empirical Study of the Arkansas Usury Law: 'With Friends Like That . . .'", 1968 University of Illinois Law Forum, 544; Rolf Nugent, "Three Experiments with Small Loan Interest Rates", Harvard Business Review 12 (October 1933).

competition is truly the final arbiter of rates. Summarizing the data in the field as it relates to cash credit, Professor Robert Johnson of the Herman C. Krannert Graduate School of Industrial Administration, Purdue University, noted: [30]

> "In earlier years, when interest rates and operating costs had not generally pressed rates to the ceiling, the maximum permitted was *not* the prevailing rate. In a study of the rate patterns among licensed lenders in 1938, the Superintendent of Banks of New York found that 108 out of 200 licensees were not charging the ceiling rate. Of course this was long before the days of rate disclosure. More recently, Household Finance Corp. reported as of April, 1969, a period of generally high money rates, that its charges on installment loans were lower than the lawful maximums under 16 different state laws (15 states). The price ceilings under which they operate permit finance companies to accept on the average less than half of new applicants, and their rates of return provide no evidence of monopoly profits.
>
> "Some excellent data are available concerning the effectiveness of rate competition on consumer loans at commercial banks. In a survey of 497 banks in 27 states made in 1969, Dr. Paul Smith found no significant correlation between rates charged and the legal ceilings. When price ceilings were high, most banks charged rates below the ceiling. In contrast, 'When the ceilings were very low, many banks charged rates above the legal ceilings. In one state, with a legal ceiling of $6.00 per hundred, the charges of 60 percent of the banks in the sample were more than the legal ceiling on small unsecured loans.' "

There is also ample evidence indicating that rates in sales credit do not necessarily rise to ceiling levels.[31] Thus, the findings of the National Commission on Consumer Finance with respect to a 1969-1970 survey of the new auto-

[30] Statement Submitted to Advisory Committee, State Senate Committee on Judiciary, State of California, September 15, 1971.

[31] Robert P. Shay, *New Automobile Rates 1924-1962* (National Bureau of Economic Research, 1963); Allen F. Jung, "Charges for Appliance and Automobile Installment Credit in Major Cities", *Journal of Business* 35 (October 1962); "Commercial Bank Charges in New York and Ontario", *National Banking Review*, 3 (March 1965); "Dealer Pricing Practices and Finance Charges for New Mobile Homes", Journal of Business, 36 (October 1963); "Terms on Home Improvement Loans", National Banking Review, 2 (September 1964); A. H. Schaff, "Regional Differences in Mortgage Financing Costs", *Journal of Finance*, 21 (March 1966); Federal Home Loan Bank Board, Release of December 23, 1969.

mobile credit market suggest that in sales credit, as in cash credit, competition, not artificial ceilings, is the final arbiter of rates:

> "In four states where the legal rate ceiling is 25 percent or above, there were no cases where the actual annual percentage rate was the ceiling.
>
> In two states where the legal rate ceiling was 21 percent, only one contract out of 121 in the survey was at the ceiling.
>
> In two states where the legal rate ceiling was 16 percent, only one contract out of 123 was at the ceiling.
>
> In 10 states where the legal rate ceiling was 14 and a half percent, only 13 percent of the contracts were at the ceiling.
>
> And in two states where the legal ceiling was 10.9 percent, some 74 percent of the contracts were at the ceiling.
>
> I might add that in these latter two states 12 percent of the contracts were above the ceiling and therefore illegal." [32]

Beyond being ineffectual governors, severe market distortions result from uneconomic price ceilings. Professor Johnson has noted that a reduction in the price of credit below the market determined rate encourages its use by consumers while at the same time discouraging the extension of credit. He finds a consequent withdrawal of credit resulting from a narrowing of margins by a reduction in revenues without a corresponding reduction in costs. The greatest impact of such credit withdrawal is on the less affluent and higher risk consumer who must, as a result, delete from his market basket the goods or services that he would otherwise have purchased on credit or possibly turn to the illegal market.[33]

An analysis of the growth and profitability of credit card banking indicates that losses on bank credit card operations are approaching for some banks 1.8% of year end outstandings and that relatively few banks reported a net profit on credit card operations in 1970.[34]

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[32] Robert L. Meade, National Commission on Consumer Finance, Consumer Credit Leader, Volume 1, No. 3, October 1971, P. 8.

[33] Address before the National Association of Consumer Credit Administrators, Bal Harbour, Florida, May 22, 1971.

[34] Andrew F. Brimmer, "Growth and Profitability of Credit and Banking", 1971 National Credit Card Conference, American Bankers Association, October 27, 1961.

The effects of uneconomic price ceilings are readily apparent in the field of sales credit. A study prepared by a national firm of certified public accountants indicates that among merchants examined there was a deficiency of service charge revenues as compared to the cost of administering a revolving credit plan amounting to approximately 2.3% of credit sales, assuming a 6% cost of capital.[35] These findings of a deficiency in revenues as compared to costs are confirmed by recent studies in the states of Utah, Minnesota, Iowa, and Connecticut.[36]

When these data are considered together with the fact that retailer's profits are roughly equal to those in other forms of business it is clear that retailers cannot simply absorb price reductions for their credit services in the form of lower profits.[37] To do so would merely mean that capital would be diverted from this industry. Consequently, if government forces down the price of credit services without a similar reduction in costs, sellers must either (1) eliminate that or some other service, or (2) more likely, raise the prices of other goods and services. If prices are raised, cash buyers who must then pay such prices are forced to provide a basic subsidy to credit buyers.[38] It is the same as if the price of alterations on men's suits were, by government decree, forced below the market level. No similar reduction in costs having been effectuated by government decree, if margins are to stay the same, the loss in revenue would have to be recaptured through higher prices for suits, thereby forcing the buyer who does not need or want alterations to subsidize those who do.

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[35] Economic Characteristics of Department Store Credit, National Retail Merchants Association, 1969.

[36] "Utah Consumer Credit Report", prepared by Dr. Roland Stucki, Chairman, Department of Finance, College of Business, University of Utah; "Retail Credit Operations Study" prepared by Ernst & Ernst (March 1971); "Determination of Credit Revenue and Related Costs", prepared by Peat, Marwick and Mitchell (1971); "Study of Finance Charges and Related Expenses of Revolving Credit Accounts of Four Connecticut Retailers for the Year Ended January 31, 1971", Arthur Anderson & Co., See also, e.g., 1970 Annual Reports of Buffums, Inc., Carson, Pirie, Scott & Co., Dayton Hudson Corporation, J. C. Penney Company, Inc., Sears, Roebuck & Co., Montgomery Ward & Co.

[37] Data from the Internal Revenue Service show earnings for incorporated general merchandise retailers during 1967 of 9.2 percent after taxes on net worth compared with a return of 9.0 percent for all manufacturing groups. Internal Revenue Service, Statistics of Income—1967, Corporation Income Tax Returns, U.S. Government Printing Office, 1971, PP. 22, 53.

[38] Statement of Dr. Maurice B. Goudzward, Assistant Professor of Finance, Graduate School of Management, University of California, Los Angeles, before Senate Committee on Judiciary, Hearings Re Senate Constitutional Amendment No. 39 (June 15, 1971); Kawaja, "The Economics of Statutory Ceilings on Consumer Credit Charges", 5 Western Economic Journal 157 (March 1967); Kenneth A. McLean, "Public Policy Implications of Credit Card Growth", at The Impact of Credit Cards—A Forum, San Francisco, California, June 5, 6, 1971.

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It is clear that there is, in effect, only one issue—who will pay for the added service, whether it be credit, alterations, or any other service—the user or somebody else.

A study of the market distortions caused by uneconomic rate ceilings in both the cash and sales credit field is found in an analysis of the effects of Arkansas' 10% Constitutional limit on interest.[39] In his study Professor Lynch found that as a result of the artificially low rate: cash prices of goods and services were higher for all consumers in Arkansas than in neighboring states; credit was generally less available; purchases were diverted to neighboring states; and the economic growth of the state had been hampered.

An even broader study was conducted by the Graduate School of Business Administration of the University of Washington following that state's reduction, by popular referendum, of permissible finance charge rates from 18 to 12 percent per annum.[40] The report contains dramatic findings. It found: that the availability of credit had been restricted and that the marginal credit risk was hurt the most; that the price of credit went up and that many consumers were now forced to seek more costly sources of credit; that many consumers were required to make higher downpayments and to purchase credit insurance; that the prices of merchandise had been increased and that extra charges were now being assessed for items and services previously provided without cost—such as check cashing, parking, gift wrapping, lay-a-way, delivery, and installation. The study concluded that to realign the economy of the state, rate ceilings would have to be increased, credit operation costs reduced and/or revenues enhanced from other sources.

Credit Costs

An analysis of the consumer credit market clearly must deal with credit costs and those matters affecting costs, as well as with revenues. For, as noted above, margins and, hence, the size of the market, its structure and its composition, are ultimately a function of the difference between revenues and costs.

There are, of course, the same type of fixed costs incident to the extension of credit as will be found in any business. Far more important, however, are the costs which

[39] Gene C. Lynch, "Consumer Credit at Ten Percent Simple: The Arkansas Case", 1968 University of Illinois Law Forum 592.

[40] "The Impact of a Consumer Credit Interest Limitation Law; Washington State: Initiative 245" (1970).

vary with the size of the operation and the nature of the market being served, including, but not limited to: the salaries of personnel associated with the opening, processing, and collection of accounts; equipment, supplies, and postage expense in connection with the posting and billing function; credit verification expenses; telephone and other expenses related to the collection function; bad debt expense; and the cost of capital to finance outstanding accounts receivable balances. Costs can also be affected by governmental action prescribing the methods a creditor must employ or not employ in conducting his business.

The significance of any particular cost item in relation to total costs will vary depending upon the type of credit grantor involved, the precise services rendered and the nature of the market served. For example, the cost of capital as a percentage of total costs may be less for financial institutions or other large credit grantors having direct access to lower cost funds. Expenses associated with the processing and billing function may be proportionately more for revolving credit accounts with multiple purchases, credits, payments, and periodic billings than for single payment loans or installment contracts. Collection and bad debt expense, on the other hand, may vary with the degree of risk with respect to the consumers served.[41] For most creditors, however, the cost of capital, collection expenses, and bad debt are the most significant items.

Capital employed by creditors to finance outstanding accounts receivable balances is not free. Money for the extension of credit may, broadly speaking, be obtained from equity funds and/or debt. In the debt category this can be accomplished by borrowing from financial institutions, much as a consumer borrows from a bank, by use of the commercial paper market, by issuance of debt securities and by discounting of receivables. For commercial banks there are also demand deposits, savings accounts, and certificates of deposit. Equity capital, on the other hand, represents funds invested by the public through the purchase of stock in a public corporation or venture capital in closed corporations, partnerships, or sole proprietorships.

Ultimately, the source of all funds, whether debt or equity, is the public itself, and ultimately, the public must

[41] Federal Trade Commission, Economic Report on Installment Credit and Retail Sales Practices of District of Columbia Retailers, (U.S. Government Printing Office, 1968).

be adequately compensated for the use of its funds if a continuing flow of capital for the extension of credit is to be assured.[42] Such compensation for the use of debt capital takes the form of interest and for equity capital the form of dividends. If the creditor's margins, either because of insufficient revenues or excessive costs, are inadequate to permit a satisfactory return on investment as compared to other industries, the availability of funds from the public will be curtailed and credit extensions diminish.[43]

The remaining two principal items of expense—collection expenses and bad debts—figure in any credit operation and are necessary for maintenance of the credit structure itself. If all consumers were to pay their legitimate obligations in accordance with their promises and if there were no defaults these costs could be eliminated. Because they do not, because there is no way to predict with certainty those who will and those who will not and because it would not be fair to impose such costs on those who do not use credit, provision must be made for such expenses within the credit operation.[44]

Costs in each of the areas discussed can be materially affected, directly or indirectly, by governmental action. By affecting costs, such action also affects the size of the market, its structure and its composition. On the operating level, for example, legislation and regulation with respect to the disclosure of the terms and conditions of extensions of credit, billing procedures, customer relations and credit verification are all cost related. This is also true on a broader scale of, for example, limitations on customer liability for credit extended and restrictions on available creditor remedies.

To illustrate, there have been legislative proposals calling for the mailing of credit cards by registered mail. In a sizeable operation the additional costs of registered mail would, of course, represent a substantial increase in the cost of credit. More important from a cost standpoint are various proposals to limit creditors' remedies—to eliminate the holder in due course doctrine, waiver of defenses, to garnishment, wage assignments, pre-judgment remedies, limit repossession rights and deficiency judgments and other collection procedures. Of course there are certain acts or practices

[42] Robert F. Brunn, "State Usury Laws and Federal Policy", The Banking Law Journal, Vol. 88, No. 11, November, 1971.

[43] Ibid.

[44] See e.g., 1970 Functional Cost Analysis, 12 Federal Reserve Districts (1971); National Consumer Finance Administration Research Report on Finance Companies in 1970, (August 1971).

whose "social costs" may be sufficiently great as to warrant their elimination or restriction. However, it must be recognized that the economic costs involved necessarily affect the extent to which the credit grantor can serve the market.

Based on the foregoing it is obvious that a creditor's margins—the difference between his costs and revenues—may well determine the structure and composition of the market. For example, to maintain margins sufficient to attract capital a higher rate or stricter remedies may be required if higher risk consumers are to be served or where a broader class of credit users is desired. Viewed from this perspective the need for a thorough understanding of the interrelationship among rate, risk, and remedy as the key to effective social policy is apparent.

V Toward a Model Consumer Credit Market

There is a need for a rational, integrated approach to the consumer credit market based upon empirical data as to the effects of eliminating or restricting specific conduct on the ability to achieve explicit socio-economic goals. The need for such an approach becomes even more critical in the light of discernible trends in consumer credit.

Population experts predict an increase in population of 14% by 1980.[45] Gross national product is projected to grow at 6.8% per annum until 1980.[46] When coupled with the statistics indicating an increasing usage of consumer credit as a percentage of disposable personal income [47] these factors compel the conclusion that consumer credit will increase in size and relative importance.

But there are additional trends which must be considered. The use of credit to satisfy financial obligations for basic needs has been supplemented by the use of credit to finance travel, education, vacations and other services. Credit cards have become, for many, a new form of cash. That is, the card is used as a convenience in facilitating payments rather than as a financing device.[48] There is also an ever increasing demand for more flexible and more convenient forms of credit.

It has been stated that in the near future charge cards

[45] Information Please Almanac (1972).
[46] Harvard Business Review, October 1971, P. 123.
[47] FN 11, *supra*.
[48] Hearings on H.R. 12646 Before the House Comm. on Banking and Currency, 90th Cong. 1st Sess. 10 (1967) (Statement of Andrew F. Brimmer).

will be used to activate electronic-input terminals thereby eliminating massive transfers of documents, and that charge cards will play a principal role in the establishment of an electronic money-transfer system.[49] Such a checkless, cashless society would undoubtedly bring with it new and different social problems. Continued technological advances and innovations can be expected, bringing with them problems of depersonalization, of greater conflicts between the need to know and the right of privacy. And then there is the ever increasing role of government—as a participant in and regulator of the consumer credit market.

The challenges posed by these trends must be anticipated, for the failure to plan for the future will pose ever increasing risks of a breakdown in the consumer economy.

The ideal consumer credit market is the one which best serves explicit social and economic goals. Whatever else, an ideal market should provide for the availability of consumer credit at reasonable rates, be free of unfair or deceptive practices, be free of artificial or unrealistic constraints inhibiting growth, and allow for the informed use of consumer credit.

It is, however, easier to agree on the characteristics of an ideal market than to structure the market possessing these characteristics. To do so requires recognition of the fact that words such as "reasonable" or "fair" are not abstracts; of the interrelationship between rate, risk, and remedy and the effect of each on costs and revenues; of how such matters bear upon the ability to achieve broad socio-economic goals. It requires recognition of the fact that there must be a reasonable return on investment if funds are to be made available for the extension of credit; that costs vary with the market served and the services provided and, thus, that a definition is needed of those to whom credit should, as a social matter, be made available; that the answer to what is a "reasonable rate" or a "fair" practice, in large measure, depends upon what is sought to be accomplished. It requires a determination of whether certain credit users should subsidize the expense of serving others, whether the cost of credit should be borne by those who choose to avail themselves of such facilities or whether it is socially preferable that the cost be distributed among all consumers. And, if the latter,

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[49] Brandel and Leonard, "Bank Charge Cards: New Cash or New Credit", 69 Mich. L. Rev. No. 6 (May 1971).

how this can be accomplished without placing the burden on some and not others? [50]

That is not to say that the ideal is beyond realization; that we, like Don Quixote, are relegated to tilting at windmills. The role of government as a monitor of economic activity is predicated on the assumption that the production, distribution, and sale of goods and services is best and most efficiently served by responsible free competition, that keeping the channels of commerce unclogged will provide the consumer with the widest selection of quality products at reasonable prices.

A prominent Congresswoman has noted:

> "This economy rests, and must continue to rest, primarily on independent judgments by millions of businessmen as to what they can or will charge for any given goods or service, and by nearly 200 million consumers on what they are willing to pay and under what terms." [51]

The goals of free competition, however, are stifled by overregulation, by artificial or unrealistic constraints, by legislatively mandated pockets of privilege or competitive advantages, by a populace not supplied with adequate or accurate information necessary for rational choice or not competent to use such information. Unwarranted competitive advantages and the elimination of certain credit grantors from the market may lead to a reduction in consumer credit options, a tendency to monopoly, restriction of credit availability, and higher prices for credit and for goods and services, whether sold for credit or for cash.

We are not suggesting the abdication of government from the consumer credit picture. Rather, we are suggesting that government has an identifiable role with parameters which should not be exceeded. Government, to be effective, must define the social goals, prescribe broad standards of conduct, refrain from costly and unnecessary overregulation, avoid the temptation to act on the basis of emotionalism or political expediency, itself provide credit services where necessary and assist in assuring the free flow of meaningful information to educate consumers. The role of government points to the need for a continuing dialogue with industry and

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[50] A number of these considerations as they bear on the English economy were discussed in The Report of the Committee on Consumer Protection under the chairmanship of Lord Crowther (1971).

[51] Congresswoman Leonor Sullivan, 92 Cong. 1st Sess., Vol. 117, No. 158, Cong. Rec. E11134, Oct. 21, 1971.

consumers, for meaningful self regulation and voluntary elimination of practices whose social cost is too great.

Fraudulent acts and practices, whether engaged in by industry or by consumers, have no place in a free enterprise system. That such practices need to be eliminated and that this is properly a role for government is beyond dispute. More difficult is a determination as to the proper role of government with respect to conduct of debatable social or economic worth or whose worth may be viewed differently depending on the ultimate goal to be served. Here it is clear that careful analysis is indicated—that empirical data is required as to the consequences of governmental action in dealing with such matters.

For example, if there is a social judgment that credit should be available to those who, as a matter of sound economics, cannot be served by the private sector, such a role must be fulfilled or underwritten by government. Government similarly has a vital role in insuring that the average credit user is both well educated and informed so as to be able to make rational choices among the various options available and to be prudent in incurring debt. This responsibility is, of course, also that of industry as is the responsibility to assist, through debt counselling, consumers who have inadvertently overextended themselves.

The role of government in the consumer credit market has traditionally been reserved to the states. The entry of the federal government into the field has not resulted in preemption but has led to overlapping, sometimes duplicative and sometimes inconsistent requirements. The federal government was prompted to enter the field because of a claim by some that the states have failed to properly address themselves to the issues of the day. There is a substantial body of opinion that consumer credit is best dealt with at the local level where local problems and conditions can be considered. If the states fail to deal with these matters in a thoughtful way, if, by action or inaction, they should burden interstate commerce with undue or unreasonable restrictions and requirements, federal action may well be required.

To date consumer credit has made a substantial contribution to the growth and vitality of our economy and to the high standard of living which we enjoy. As a valuable public service, consumer credit must be encouraged to flourish within a competitive setting in which efficient credit grantors

are stimulated to offer a wide variety of credit options to credit educated consumers. Well balanced and consistent approaches to the resolution of legitimate disputes are required, as are programs designed to promote public understanding and awareness of the role and functioning of consumer credit in our society. The future of the consumer credit market depends on the ability and willingness of consumers, industry and government to recognize and work together toward a resolution of the challenges posed.

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CREDIT CRITERIA AND AVAILABILITY

Committee on Credit Criteria and Availability

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To a degree, this topic relates to an area also within the scope of those matters assigned to the committee dealing with "The Role and Function of Consumer Credit." To avoid unnecessary duplication, this committee has, therefore, focused its attention primarily on the applicability of this topic to the individual consumer. It has also included a consideration of the problems of over-extension since they are interrelated to credit availability.

Before reviewing the problems of the individual consumer in this area, this committee wishes to record the fact that it has considered those factors currently operating and tending to diminish the availability of credit generally, and particularly to persons in the low income category. The particular factors involved are described in other reports and there is no need to extensively comment on them in this report. Nevertheless, it must be stressed that the continuing attacks directed at the reduction or extinguishment of creditor remedies, both at Federal and state levels, to the extent they are successful, create additional collection problems and hence increase the risks involved in extending credit. Similarly wide-scale attacks on the time-price doctrine aimed at bringing the usury laws into application have resulted in some curtailment of availability of certain forms of credit transactions in certain states to the consumer. Finally, this committee recognizes that the wave of class actions, many of which are wholly without merit or based upon bare tech-

* Mr. Olson retired from the Ford Motor Credit Company and resigned from the NBCCA in February, 1972.

nicalities, is a restraining factor on the availability of credit. Not only do these actions result in hostile and biased publicity, but they also result in tremendous expenses incurred in defending them. If this trend continues unabated, more and more grantors of credit will be discouraged from extending further credit except under the most stringent terms, thereby avoiding marginal risks.

It is of interest to note that because of the concern of credit grantors to their possible exposure to class action suits and their potential liability to tremendous damages that the Board of Governors of the Federal Reserve System, in its Annual Report to Congress for 1971 on its Truth-in-Lending activities has recommended changes in the civil liability section of the Act. Their recommendations, if adopted, would provide a "good faith" defense to credit grantors and also would seek to establish a maximum liability or otherwise limit the scope of potential class action liability should it finally be determined that class actions are allowable in Truth-in-Lending suits. At present there are over 70 actions which have been brought under Section 130 of the Act. Some United States District Courts have flatly refused to allow Truth-in-Lending actions to be brought as class actions.

Recently in the United States District Court for the Southern District of New York, the court, on February 14, 1972, in the case of *Ratner v. Chemical Bank New York Trust Company*, involving a potential damage exposure of $13,000,000, refused to maintain the action as a class action for a class of approximately 130,000 card holders. In its strong opinion, the Court stated that, ". . . the proposed recovery of $100 each for some 130,000 class members would be a horrendous, possibly annihilating punishment unrelated to any damage to the purported class or to any benefit to defendant for what is at most a technical and debatable violation of the Truth-in-Lending Act." A week earlier, in a case appearing in the same court titled *Heart Disease Foundation v. General Motors Corporation*, the court, in dismissing anti-trust allegations that the automobile maker conspired to retard pollution preventing devices stated that, ". . . perhaps plaintiffs and their counsel have failed to realize that the damages sought are some 300 times more than the annual gross national product of the United States."

I. Credit Criteria

A. Application of basic credit criteria

In initial discussions of the availability of credit to

individuals it was the general consensus that consumer credit is presently available in sufficient amounts to meet the normal needs of all but the low income consumer who demonstrates a responsible payment record and a willingness to pay. For the credit grantor applying uniform standards, ability and willingness to pay continue to be the major criteria in determining whether credit should or should not be extended in the individual case. Denial of credit based on discrimination because of race, creed, or sex should be eliminated even if it is not already proscribed by existing law. It would appear to this Committee that the increased use by credit grantors of statistical scoring systems and techniques based on objective standards uniformly applied tends to eliminate discrimination.

In certain situations the address of the consumer remains a present and vital factor directly affecting the availability of credit for the individual concerned. Where credit extension depends on the location of an office in an area with a high incidence of crime, the frequency of robberies may force the office to close and move elsewhere. Likewise in areas where collection activities become too hazardous for the collectors to operate, credit availability will diminish accordingly for consumers living in that area.

This Committee is keenly aware that the problem of credit grantors avoiding crime infested areas is only symptomatic of the more serious problems now facing the nation involving densely populated low income urban areas. The complexity and magnitude of these problems extend far beyond the credit area.

B. The unresolved socio-economic issues

The focus of this committee's attention on the availability of credit for the low income consumer raises a number of problems, many of which are presently unresolved and do not offer promise of adequate or immediate solution. These problems involve the rehabilitation of the urban ghetto areas, not only in terms of housing, but also in terms of crime reduction and prevention, educational improvements, job training, job opportunities, and welfare reform. Until substantial progress is made there is little cause for optimism that large numbers of low income consumers will be able to obtain credit from credit grantors.

A recognition of this desire for credit by consumers in the low income category raises the serious problem as to who should obtain it and who should be refused credit. There are those who are firmly convinced that credit should not be extended to consumers in this category since it increases the risk factor to the credit grantors, and the results of over-extension are particularly damaging and harmful to the low income consumers in this group. On the other side, there are those who would seek to broaden the class of people utilizing consumer credit while at the same time ignoring the increased risks and costs to the creditor, and urging that the restriction or removal of the creditor's remedies be encouraged while at the same time ignoring and disregarding the consequences of such action. Advocates of this "easy credit-away with remedies" philosophy are faced with a self-defeating contradiction. As the remedies are weakened and the loss increased, the credit grantors will tighten their standards for extending credit, thus decreasing its overall availability.

As pressure from these groups increases, so will the opposition to such tactics. This committee is convinced that such tactics must be firmly resisted without governmental interference and that the decision to grant or deny credit must finally remain with the credit grantor. Where credit grantors have yielded to such pressure, the results, both to the credit seekers and to the grantors, have not proved generally successful. It is evident that any yielding to such tactics will increase the cost of credit and produce a prompt counter-action to offset the cost increase. The additional cost may have to be shared by the more credit worthy customers and probably also by the cash customers.

Meanwhile, it is pertinent to note the results of the application of uniform credit criteria to consumers in the low income category. While it is acknowledged that many individual factors are taken into account in processing a credit application, there is no uniform pattern. It is agreed, however, that the final determination of whether credit will be extended rests on the recognition of the ability and willingness to pay the debt obligation. Though the willingness to pay attitude may be always present with a consumer, the ability to pay factor is subject to sudden and abrupt change. Unless the consumer has established reserves, a serious and pro-

longed illness or loss of employment may frequently lead to a default situation. There is no question that the probability of a default situation occurring is more likely with consumers in the low income category. Because of the application of the ability to pay factor by most credit grantors, the majority of low income consumers are either excluded from receiving credit or receive less than desired amounts.

C. Application of modified credit criteria standards

The preliminary report on consumer credit and the low income consumer issued by the Urban Coalition in 1969 provides an interesting insight and study of efforts made by commercial banks, credit unions and retailers to make consumer credit and consumer education available to low income consumers. The report seeks to "identify ways to increase the availability of reasonably priced credit to low income families." In the summary of this report the authors have acknowledged that it represents "a tiny step in solving a huge problem." They further note, perhaps more significantly, that bankers and retailers who have participated in the program and involve themselves in the low income credit market have been obliged to utilize and apply different or new standards to determine credit eligibility. Many of these new programs, established on an experimental basis, have resulted in high loss rates for the participating creditors. However, it is possible that as welfare payments continue to increase on a wide scale basis, larger numbers of low income consumers may find at least a portion of their welfare income available for regular credit purchases.

It is the consensus of this Committee that "demonstrated ability and willingness to pay" must remain the major criterion for the extension of credit to all consumers. While the application of modified standards may permit the extension of credit to small numbers of low income consumers with acceptable risks, it is unlikely that most credit grantors would or should accept these risks when applied to substantially larger groups.

II. A Consideration of Government Roles in Providing Credit to Low Income Consumers

State government has long been deeply involved in regulating consumer credit and now the Federal government is becoming increasingly involved. But it is private enterprise

which provides both the credit and the structure for extending it. This outline covers a consideration of the range of government involvement which varies by level of government and by degree of intervention. There is what is termed a competitive approach—indirect intervention to permit the existing system to function more efficiently and equitably. As an alternative there is a regulatory approach—direct controls designed to channel credit to those who now get little. There are, in addition, intermediate forms of government action which fall in between these two extremes.

A. Competitive approach

1. Under existing state regulation the consumer credit industry operates under a confusing, overlapping maze of usury and sales credit statutes. Their effect has been to artificially segment the market, reduce competition within the industry and restrict the entry of new firms, channel existing sources of credit, and establish a complex of ceiling rates.

One form of government action would be to reduce regulation and to simplify and to reform existing state law. The objective would be increased freedom of the credit market and broader protection for consumers. The Uniform Consumer Credit Code is an attempt to do this. In addition to providing broader protection for consumers, its other primary objectives are to increase the availability of credit and to lower effective rates. Both these latter goals are to be achieved by substantially increasing competition among lenders through facilitating entry of new firms into the credit industry and by removing barriers to the free movement of credit grantors within the industry.

The Code abolishes most ceiling rates but sets a single structure of maximums to prevent unconscionable charges; however, the belief is that increased competition will result in effective rates below these maximums. It establishes a credit administrator whose broad powers provide flexibility to meet changing conditions. Disclosure provisions are drawn to permit state rather than Federal administration of Truth-in-Lending.

This form of government action seems desirable. It works entirely within the free market, and, compared to present law, it reduces the amount of detailed government regulation. Increased leeway for competition could increase the supply of credit to all income levels, while

hopefully reducing effective rates. Further, adoption of the UCCC by all states would produce a simple, uniform system of consumer credit law throughout the nation. And finally, it would help retain regulatory control at the state level. While it is unclear how much more credit would be available to the poor under the UCCC, in time the experience of states which have recently adopted it may provide an answer.

While this Committee supports the passage of the UCCC, it is fully cognizant of the responsibility of business on a voluntary basis to be more responsive and prompt in dealing with legitimate consumer complaints. Failure in this regard invites legislative action at both Federal and state levels.

A further impetus to increased competition in the granting of consumer credit would come from adoption of two recommendations of the Commission on Financial Structure and Regulation. One would permit savings banks and savings and loan associations to make consumer loans; and second would permit credit unions to expand their activities by becoming public banking institutions.

The Committee assumes that if either of these recommendations were adopted, these institutions would be subject to the same taxation as other competing lenders.

2. Another form of indirect government intervention would take the form of studies of certain aspects of the credit market.

Examples of such studies underway by the National Commission on Consumer Finance are: Determination of the characteristics of good and poor risks among low income consumers for designing credit criteria for the poor. A second study evaluates existing experimental credit-granting programs of banks and retailers. It will determine their effectiveness and the value of expanding such programs. Still other studies of this kind might cover lending practices which result in discrimination, fraud or deception.

B. Intermediate approach

There are other types of government sponsored or financed programs representing more intervention in the marketplace than envisioned in the competitive approach. Examples are:

1. Programs of consumer education, counseling and

credit pre-screening. These could be given by banks, credit unions, consumer finance companies, and retail associations or by community groups or government agencies. To the extent they assist the participants in qualifying for credit, more credit may become available.

2. Government funds could be deposited in banks and credit unions with commitments to provide credit to the poor, thus expanding their lending capacity.

3. Under existing law credit unions can be established in low income areas, with residents eligible for membership and thus consumer credit. A bill introduced in Congress would encourage the formation of these low income credit unions by subsidizing their organizational and operating expenses for five years. They would also be eligible for federal loans to increase their lending capacity and for 90% guarantees on their consumer loans. But such programs would be strictly limited to extension of credit to the poor.

Such a program could be taken one step further by Federal subsidization of the interest costs of such low income consumer loans. Even with this it seems improbable that with the principal at risk credit grantors would be interested in participation. This role by government is not recommended.

C. Regulatory (Direct) approach

This would treat the consumer credit industry as a public utility with the aim of enforcing a flow of credit to the poor. This cumbersome form of regulation would require massive government intervention in the marketplace. For uniformity of law, Federal regulation would be needed. It would include a complex of laws on eligibility standards, lending practices, and perhaps maximum rates. A substantial, costly bureaucracy would be needed to supervise and enforce compliance.

A variety of adverse effects would probably follow. Depending on ceiling rates, there might be a substantial reduction in the number of credit grantors due to high default and administrative costs. This in turn would probably reduce the supply of credit.

In addition, experience has shown that regulatory bodies set up to represent the public interest may end up representing the interests of those they are supposed to supervise and control. And finally the regulatory ap-

proach really could not guarantee any substantial increase in the availability of private credit to the poor.

III. The Over-Extension of Credit

Any review of attempts to make credit available to low income consumers also must include the problems of over-extension of credit and the harm over-extension can do to the individuals involved and society as a whole.

A. The Credit Granting Process and Related Problems

"Ability to Pay" and "Willingness to Pay" have long been the criteria used by the credit industry in granting consumer credit. Both have been the subjects of the credit application investigation process. Over-extension occurs (i) when the credit grantor errs in his judgment of the applicant's ability to pay, (ii) the applicant overestimates his ability to pay, or (iii) an irresponsible seller pays little or no attention to the consumer's ability to pay and loads him with debt. "Willingness to Pay" probably contributes to over-extension of credit to a lesser degree of the two criteria. Disregarding those few credit seekers who have destroyed their own ability to obtain credit by completely disregarding their obligations to pay previous debts, the major causes of unwillingness to pay are the consumer's loss of income, payment misunderstanding, ignorance and error, and a conviction that he has been cheated, disregarded or sold defective or shoddy merchandise. It is, of course, the continuing responsibility of business to make every effort to eliminate and remedy those causes based on its own faulty operations or mishandling.

Ability to pay has become more and more difficult for a credit grantor to determine. Credit is used in today's society for a wide variety of goods and services, and cash is used less and less until the end of the month when the bills come in. No longer is credit requested by the consumer for "large ticket item" purchases only and cash used for day-to-day living expenses. Instead, many consumers "charge" when possible and pay cash only when necessary. The variety of credit grantors available to each individual consumer and the near impossibility of determining the extent of the consumer's current debt or his potential future debt have reduced the grantor's capability of protecting the consumer from over-extension by restricting credit at the outset.

Most credit grantors are familiar with situations

where our existing credit information system has produced inequitable results for consumers. A careful analysis will show that it is inadequate or inaccurate information, rather than too much information, that is the basis for most complaints. The 1971 Federal Fair Credit Reporting Act, although not so intended, limits credit information presently available. Some persons are advocating further restrictions on the basis of "invasion of privacy" and other similar catch phrases. Such action may be far more harmful to the consuming public if it results in over-extension of credit or possibly the curtailment of credit availability. The grantor must have sufficient information to make a good credit decision.

In today's era of financing availability through finance companies, revolving charge accounts, bank credit plans, and credit cards for travel, gas, food, lodging and almost anything you can think of, the trend to buy now and worry about payment later tends to cause the consumer to become over-extended unwittingly. This tendency is not confined to any one particular income group.

Irresponsible selling practices are receiving more notoriety today than ever before and we can expect this trend to continue. The visibility given these practices through the consumerism movement and a variety of governmental and independent agencies, newspaper and television "action lines" and counselling and law services have made these practices unpopular, if not unprofitable. We must recognize that the market undoubtedly will always have some irresponsible merchants. Over-extension in this case is caused by a third person, the seller, without regard for the resulting effect on the creditor or consumer.

It is to the clear advantage of the credit granting industry, a great majority of which is represented by responsible businessmen, to react vigorously and promptly to police its own house against irresponsible business practices. This can be accomplished by persuasive efforts or by means of concerted action through trade associations, the council of Better Business Bureaus, or other similar organizations.

Unwillingness to pay usually occurs after the transaction is consummated, except in those situations where the applicant has a pre-conceived intent to avoid payment and to defraud the credit grantor. Obviously a

credit grantor does not extend credit to an applicant whose intention is not to honor the obligation. Much like the above, a third party, the seller or manufacturer, causes the consumer to become disenchanted with his purchase and to make a conscious decision not to continue payments.

B. Problems Resulting Generally from Over-Extension of Credit

It is important to recognize that over-extension of credit is a condition and not an event. Although any single grant of credit may result in the situation where the consumer has become indebted beyond his capacity or willingness to pay, this condition usually, if not always, is the result of a series of events. Many consumers get in an over-extended condition after the debts are incurred when their ability to pay changes due to loss of income caused by illness, unemployment, etc. We should not be trapped into attempting to provide a means of preventing only the last grant of credit that precipitates the condition. In connection with each grant of consumer credit, the credit grantor must be concerned not only with the present ability of the customer to pay, but also his potential ability to pay in the future.

We must recognize that over-extension of credit affects everyone and does particular violence to the consumer involved. As credit grantors, we are apt to view the consequences in terms of nonpayment or other default resulting in the necessity for extensive and expensive collection activity, repossession, wage garnishment, levy on personal property, or the employment of other traditional creditor remedies. These are, of course, important consequences of credit over-extension, but the consequences to the consumer and to society in general are even more significant. Everyone loses when this condition exists. The consumer is placed in a distressing atmosphere; he may lose the property he has acquired on credit; he may lose a portion of his income necessary for the maintenance of his family and household; he may, in fact, lose his job or be driven to desperate measures. Bankruptcy and divorce sometimes result. Society in general ultimately must pay the cost of the losses to the credit grantor and, more importantly, account for the adverse effects on the consumer.

From its very inception, the credit industry has been seeking ways to avoid acquiring consumer obliga-

tions likely to result in nonpayment or other default. The entire credit screening activity as well as arrangements for extensions, rewrites, etc., are dedicated to this end. In addition, the industry has been in the forefront in providing consumer credit educational facilities, consumer credit counselling services and other similar devices to assist the consumer in avoiding situations which may jeopardize his credit.

C. Over-Extension of Credit to Low Income Consumers

Both the economic and social consequences of over-extension of credit must be considered, particularly when developing programs aimed at making adequate credit available to low income consumers. It is believed that the low income consumers are more susceptible to the pitfalls resulting from credit over-extension. As a group, they tend to be less prepared to budget their disposable income, their income amount is less able to absorb even temporary setbacks and their provisions for difficult times are almost non-existent. These groups are the prey of irresponsible sellers and those who will bend the truth to close a sale. These groups are less able to get satisfaction when goods or services they have purchased do not perform up to expectations.

Having fallen into the pitfalls of over-extension, low income consumers are less able to recover and the results could have a lifetime effect on the individual's ability to obtain credit, necessities of life and some of the pleasures he so eagerly desires.

D. The Role of Business in Protecting Against Over-Extension

What can business do to help consumers avoid situations where they incur debt beyond their capacity to pay? It is imperative that businessmen support all worthwhile programs designed to alleviate these situations. Equally important, businessmen must resist with all appropriate means the well-intentioned, but ill-advised, efforts of those who seek to treat only some of the symptoms of over-extension of credit without due regard to the credit system as a whole. The following are some areas in which businessmen must become or continue to be active:

1. Expansion of the Credit Information System

Business must encourage development of a vastly improved credit information system and must resist efforts of those who would further curtail information

available with respect to debtors. To the extent that credit grantors are obligated to operate on the basis of skimpy, insufficient or incomplete information, the risks of over-extension of credit to individuals who are low credit risks are increased and expanded over and over.

Once current and adequate information is obtained by the credit grantor sufficient to make a sound judgment resulting in the extension of credit, the job is not completed. For the credit grantor operating at multiple locations there is a continuing obligation to make certain that established credit standards are applied uniformly and soundly at each location.

The only apparent alternative to the remedies previously employed by credit grantors is a vastly improved credit information system. Every effort must be made to resist additional restrictions on the availability of credit information and to promote improvements to the system that will limit the possibility of error and preserve the confidentiality of the information concerning the consumer without impairing the effectiveness of the system. No other single action taken by business can be as effective to prevent over-extension of consumer credit.

2. **The Encouragement of Consumer Credit Education**

Businessmen must encourage educators to require courses in personal money management and participate in developing and implementing such programs independent of the educational system.

Even though an improved credit information system can provide business with an indispensable tool for better controlling over-extension of consumer credit, the ultimate responsibility lies with the consumer himself. The long-range solution, if there be one, rests in better consumer education. Apparently, personal money management courses are available on an optional basis in only a limited number of secondary schools. With all of the grief and heartache attached to poor money management, it is strange indeed that the educational establishment has not directed more of its energies and resources to this area.

Educators should be encouraged to develop and install an adequate curriculum for this most important part of everyone's education.

Business has the capability of supplementing educators' efforts by producing advertising and training

material on money management to provide the consumer with continuous assistance in spending his income wisely.

One prominent example of a business supported agency operating in the consumer education area is the National Foundation for Consumer Credit. Its activities have been devoted to education, research and counseling in the field of consumer credit. Some other organizations operating effectively in this area are National Consumer Finance Association and Household Finance Corporation's Money Management Institute.

3. The Encouragement of Consumer Credit Counseling

Businessmen should be encouraged to support consumer credit counseling activities both financially and by direct participation.

In 1968, the Family Service Association of America published a report of its study of consumer credit counseling provided by non-profit, community-based programs. This study was financed primarily by individual credit granting businesses and has resulted in some expansion of this new community service. Consumer credit counseling programs are being established in additional metropolitan areas and are receiving support from local businesses. These organizations provide debt counseling services and in some cases, debt adjusting services. They are operated on a nonprofit basis and have proven their worth in almost every instance. Although these services deal primarily with the consequences of credit over-extension, they also assist distressed debtors who have successfully solved their problems from again becoming over-extended.

Prominent also in the counseling area is the National Foundation for Consumer Credit and the Consumer Credit Counseling Services located in many cities in the United States and Canada. These organizations are independent and industry supported, with a loose affiliation to the National Foundation. They serve to provide free credit counseling to individuals who are overextended in their credit obligations. These agencies try to arrange for the repayment of debts through an established plan in order to avert bankruptcy. Their work is not to be confused with the activities of "for profit" debt consolidation agencies which are under attack in many areas.

4. Restrictive Credit Programs

The credit industry must refuse to support the activities of irresponsible merchants in the sale of goods and services who, although few in number, can, by the employment of unfair practices in dealing with the consumer public, mar the reputation of the entire industry.

Of course, it is not always possible for a credit grantor to determine that fair practices were followed in consummating a sale, or that warranties made will be honored. However, the grantor does get clues to unfair practices from the credit statement and from his mail bag. Counseling with merchants involved for corrective action and the threat of eventual withdrawal of credit lines if necessary would make a major contribution to the consuming public.

5. Reevaluation of Consumer Credit Limits

The individual's ability to pay should be reevaluated by each credit grantor from time to time and new credit limits established on current data. While the establishment of a reevaluation program operating on a regular basis may present some problems, the benefits to be derived from such a program to both credit grantor and consumer far exceed the disadvantages and problems in setting such a program up for operation.

The growing popularity of revolving charge, bank credit cards, etc. has tended to establish life-time credit lines for individuals. Unfortunately, these credit lines are often reviewed only when the individual is in trouble and doesn't pay. Credit grantors of this type can alleviate credit over-extension problems for consumers by reevaluating their current ability to pay periodically and establishing new limits based on up-to-date credit data.

6. Support of Improvements in Bankruptcy Procedures

The importance of the bankruptcy problem cannot be ignored when approximately 160,000 new personal straight bankruptcies occur each year, the greatest percentage of which are consumer bankruptcies representing a financial calamity to the debtor and his family. Discharge, in many cases, is not a permanent solution for the debtor for, unless the discharge is properly pleaded as an affirmative defense, in any subsequent actions on the claim a default judgment may result.

Businessmen should encourage the enactment of a bankruptcy law that will have a truly rehabilatory effect upon debtors and provide relief from the unconscionable tactics of some avaricious creditors. At the same time, we must be alert to prevent the bankruptcy law from becoming a convenient device through which financially able debtors may escape their legitimate obligations without penalty or censure.

In the United States, Canada and some few other nations, bankruptcy law has developed as a device for the relief and rehabilitation of distressed debtors including individuals. In most other parts of the world, bankruptcy is a creditor's remedy providing for the marshalling and distribution of the assets of a debtor for the benefit of his creditors. Individuals long have been permitted to take advantage of our Federal bankruptcy laws. Chapter XIII, relating to wage earner receivership, has had a mixed reception. In only some 14 states is it used extensively and quite successfully, in other areas it is seldom if ever used.

Despite the enlightened view of bankruptcy that has generally prevailed in our country, its operation has not been entirely satisfactory to debtors, general creditors, secured creditors or others. Changes constantly are being suggested. At the present time two massive studies of the entire system are nearing completion; one by the Brookings Institute and the second by the National Commission. We should become familiar with these reports and use these data as guides in developing a position on bankruptcy reform.

E. SUMMATION

Over-extension of credit is caused by a variety of series of events and circumstances leading to a final condition. Business and businessmen must recognize the pervasive and pernicious effects of the over-extension of credit and the tremendous effects it has on individuals' lives and costs it imposes upon society. We must utilize self-policing measures that are designed to reduce the harsh impact of traditional creditor remedies on the deserving but distressed consumer. We also must work for more adequate educational facilities and support programs for the rehabilitation of over-extended debtors. We must be vigilant, however, to resist short-sighted legislative and juridical changes that will impair or destroy our ability to provide an appropriate level of credit to all consumers in the future.

F. CONCLUSION

This Committee's assignment, although restricted in scope, encounters at once what is probably the most sensitive of all consumer credit issues: Who should or should not be extended credit? It is an issue of imposing significance to those millions of families in the United States who are described as being in the low income category.

The desire of these consumers for credit has been evidenced in recent years not only by the actions of the National Welfare Rights Organization and other organizations, but also has been documented in various scholarly studies appearing during the same period.

At the same time, the credit granting industry has been subject to opposing forces on each side of the question—those who believe less caution should be exercised and more risks assumed in extending credit, and those who believe that prudence and fixed standards must be exercised in the extension of credit so as to reduce the risks resulting from the likelihood of over-extension. It is the firm conviction of this Committee, however, that whether a particular consumer is or is not entitled to credit from private sources must always remain a question for resolution by each credit grantor to whom application is made. Governmental intervention in this decision making process should be limited to providing a legal structure in which the forces of competition will be permitted to operate as freely as may be consonant with an overriding objective of fair and equitable treatment for the consumer. At present the efforts of the regulators are dominant as opposed to the advocates of free competition in the consumer credit area. Many examples of this dominance are available. Perhaps the best example is reflected in the widespread and continuing efforts initiated and supported by consumer advocates to reduce and fix low finance charge rates by legislative action from state to state. Such activities find vigorous support on the basis that low rates for the cost of credit are good per se. Little or no consideration and weight have been given by consumer advocates to cost studies presented to support the existing rate structures. Thus, no freedom is allowed in this area for competition to function.

This Committee is certain that, to the extent competitive forces within the credit granting industry continue to be increasingly shackled by heavy restrictions, the opportunities which otherwise might become available in the industry to compete on a sound economic basis to extend credit to individuals in the low income category will be stifled. If such

a course continues, some form of government participation may become the only available alternative. To this Committee such a result would be highly undesirable and would, in the long run, be less productive in increasing the availability of credit than if the problem were handled by a freely competing industry.

In the present climate there is no disposition on the part of the credit granting industry generally to modify its basic adherence to the concepts of "ability to pay" and "willingness to pay" as the major criteria to be exercised in determining whether credit should be extended. Admittedly, adherence to these criteria will tend to exclude from the extension of credit most consumers in the low income category. On the other hand, an abandonment or relaxation of these criteria will undoubtedly lead to increased and magnified problems resulting from over-extension.

In this report the Committee has noted the efforts taken by certain banks, credit unions and retailers to accommodate low income consumers by extending credit under modified standards. These efforts have met with modest success but this Committee is convinced that application of these modified standards on a wide scale basis would expose credit grantors generally to unacceptable risks.

While the basic question of who should or should not receive credit remains unsettled, it is urged that efforts continue to seek enactment by states of the Uniform Consumer Credit Code. This law may increase the availability of credit and, to the extent that lower rates may become effective through increased competition, benefit consumers in the low income category as well as others. At the same time this Committee believes that the development and expansion of programs for consumer education, counseling and pre-screening should be encouraged.

As discussed in Part III of this report, the problem of over-extension of credit is one of equal significance with that of availability. In no way should we forget that the consumer credit industry has attempted to prevent over-extension of credit. Some would indicate that the industry only dealt with its consequences, but nothing could be further from the truth. It is recognized that the results of over-extension are particularly disastrous to the low income consumer. We believe that the six point program presented to business in Section III-D above to deal with this situation and to relieve the problem is deserving of support and encouragement.

CONSUMER CREDIT BILLING PRACTICES

Committee on Billing Practices

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The consumer's most frequent and constant contact with the credit system occurs in the billing process, since virtually all consumer credit arrangements involve a regular billing-payment cycle. With the enormous volume of interactions involved, even a fractional percentage of errors and misunderstandings amounts to a large number on a national basis. Thus, credit billing practices have become a major focus among consumers and their advocates.

Consumer credit users have a right to expect billing practices which are timely, informative, and accurate. Some errors by the credit grantor or the customer are inevitable, but when they occur, procedures should be available for a swift and fair determination of the cause of the problem. This report seeks to set forth operating guidelines for credit grantors which will help put these principles into practice. The report covers lender-customer relationships in the billing process for all transactions except those involving delinquent accounts, which is the subject of a separate committee report.

The following sections discuss the major components of the billing process, and state the guiding principles which should be instituted by credit grantors in each area. Many

credit grantors use some or all of these principles now. If they are adopted by all credit grantors, the Committee believes that the American consumer will be better and more fairly served in this essential part of the consumer product marketplace.

I. Communications to the Customer

A. Information on Terms

No principle is more basic in the consumer credit market than the right of the customer to full knowledge of the terms of the agreement in which he is participating. Legal standards in this regard have been promulgated under the regulations pursuant to the Federal Truth-In-Lending Act, but responsible credit grantors should go beyond the letter of this law wherever it aids the customer's understanding of the credit arrangements involved.

In this process, credit grantors should make the terms of agreement available to customers, in clear and simple language, at least at the following times:

1. At the initial point of agreement with the customer.
2. In the case of credit cards, whenever new cards are issued, and
3. Upon request of the customer.

Depending upon the type of transaction, and the nature of the credit granting institution, many other opportunities will occur to enhance the borrower's knowledge about the system he is using. It should be emphasized therefore, that the actions listed above are minimum standards for good credit practice on this point.

B. Information on Billing Statements

1. **Identification of charges.** This should be provided to the customer in a clear and unequivocal manner, either by transmittal of copies of the original charge papers signed by the customer or by other specific identification of the charges incurred.

Some companies are moving progressively toward a system which reduces the proliferation of paper found in the typical consumer purchase credit transaction. The growing capability of computer systems to render complicated billing lists and cycles more efficient is contributing to this trend. Thus, it is expected that descriptive billing on statements to customers, as a substitute for transmittal of charge chits, will continue to

grow in use. Good service to the customer in this regard requires that the descriptions included in billing statements of prior transactions be specific enough to allow the consumer to readily verify the listing with his personal records of prior purchases.

2. **Corporate address.** This should be provided in detail, to allow the consumer to communicate directly with the billing company when a problem arises. The address should include the corporation name and any codes necessary to speed the correspondence to the proper location for prompt review and action.

3. **Telephone number.** Depending on corporate practice on the handling of consumer inquiries and complaints about billing statements, a telephone number may be included directly on each statement to facilitate this process. Many nationwide businesses with highly mobile customers do not find it feasible to follow this practice. However, especially on the local level, telephone handling of consumer complaints and inquiries is an efficient, effective, and personal way to handle these problems. In these instances, prominent display of a telephone number for customer use is a desirable practice.

4. **Name of individual for contact.** Also depending on corporate practice, the name of an individual for contact by telephone, or by written correspondence, may be made on the billing statement.

5. **Written correspondence.** In some cases, it is desirable to encourage consumers to communicate by written correspondence with respect to complaints on their billing statements. This is especially true in the case of nationwide firms without local processing offices in each major city, since the costs of long distance calls and leased lines may be prohibitive. Also, in all cases, the written correspondence documents the inquiry in a way which adds to correct and efficient processing and reduces confusion, especially in complicated cases.

6. **Emphasis on full or partial payment.** This should be equal for the total amount due and payable with no further interest or finance charges, and for the minimum payment due under the terms of the agreement with the customer. All billing statements should avoid bringing undue attention to the partial payment option. Consumers have the right to choose between the

two figures, or any intermediary amount, but the billing corporation should not seek to encourage the consumer to pay either amount through emphasis in type size or billing format.

7. **Statements unrelated to the actual bill.** These "marketing" entries should be held to a minimum on the billing statement. The purpose of the statement is to inform the customer of the charges added to his account during the previous billing period and the amounts due and owing to the company as of the billing date, as well as other factors related to his bill and his payment, e.g., the date on which the next payment is due. Entries on the billing form which tend to detract from the basic information of the communication should be avoided, including advertisements or other messages unrelated to the bill at hand. In general, these messages are more appropriately included on a separate enclosure along with the billing statement.

II. Customer Inquiries and Complaints

Unless a complete response to a consumer inquiry or complaint is given in a reasonable time, i.e., one week to ten days, an acknowledgement of the receipt of his written inquiry should be sent to inform the consumer that his problem is being investigated. This acknowledgement can take a variety of forms from a standard postcard notification, to a personalized letter, to a direct personal contact by telephone or otherwise. In the case of inquiries and complaints associated with errors on the billing statement, correction of that error in time for the correction to appear on the next billing statement sent to the customer is a proper resolution of the problem. If a customer is to receive another billing statement prior to the resolution of the billing problem he has raised, he should be sent an interim acknowledgement informing him that his concern is being acted upon by the company.

During resolution of a dispute raised by a customer, the amount in question should be suspended from the subsequent billing statements as due and owing to the company. This suspension should hold until a final decision is made by the corporation on the consumer inquiry, at which time the account may be reactivated under normal procedures.

Overdue notices should also be suspended during the period of resolution of a customer question about his account.

However, bills may continue for the remaining amount outstanding on the customer's account which is not in dispute.

Cancellation of a customer's account should not be based, in whole or part, on any question relating to a dispute between the corporation and the customer during the time while that dispute remains outstanding. Cancellation is appropriate on other grounds, however, but this reason should be made clear to the customer at the time that the cancellation decision is communicated to him.

The length of time taken to resolve a customer complaint will vary depending on the nature of the complaint and its complexity. When third parties are involved, as in the case of a customer complaint about a product purchased with a credit card, the resolution of the dispute will necessarily take a longer time. In some cases these disputes may involve transactions which have taken place at distant locations from the billing corporation, or the customer's home area. In some cases, foreign companies may also be involved.

On well communicated, clear cut inquiries from customers, responsive answers should normally be forthcoming within the next billing cycle. Except in rare cases, no more than two billing cycles should be used by the corporation to give a responsive reply to the customer.

III. Posting of Credits

Payments received from customers should be posted on the date of receipt, or as of the date of receipt by the billing company. In some cases this factor is not significant unless the final date of the billing cycle is involved, as in the case of travel and entertainment cards, which do not charge interest rates on outstanding balances so long as the complete amount is paid during each billing cycle.

In the case of revolving charge accounts, the effective date of posting of payment can be a significant factor if the average daily balance method is used to compute interest charges, or if a delay in posting otherwise can result in higher charges to the customer. In these cases the customer should receive credit on his account for his payment as of the date it is received by the company.

In addition, credit balances should always be shown clearly on any bill sent to a customer. Standard practice should call for an automatic return of credit balances to customers upon request.

CREDITOR REMEDIES AND COLLECTION PRACTICES

Committee on Creditor Remedies and Collection Practices

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I. The Nature of the Problem

Creditors extend consumer credit, expecting to be repaid. Consumers charge purchases or borrow money, fully intending in nearly every case to meet their repayment obligations. The overwhelming majority of these consumer debts *are* repaid without any difficulties between credit grantor and borrower.

This report deals, however, less with these transactions than with the cases in which disputes arise or in which the customer defaults. With over $120 billion in consumer debt outstanding, the delinquent debt problem comes to approximately $2.4 billion on perhaps 4.4 million late-paying or non-paying accounts out of a total of 174.5 million (see Appendix I).

For the creditor, maximum recovery is essential to control costs and to maintain profitability. For the consumer, the collection process may prove irritating, embarrassing and costly. It can also involve him in legal procedures, such as garnishment of his wages or loss of personal property.

In recent years, public concern about collection practices

and creditor remedies has grown as awareness of consumer problems has spread. Contributing to this is the experience of consumers who have received coldly worded dunning notices when payment was already in the mail; who have been frustrated by impersonal computer billing errors; or whose requests for repair or replacement of faulty merchandise have gone unanswered, while receiving increasingly urgent demands for payment.

Few creditors have been altogether uninvolved in creating the present mood. Those responsible for collections have traditionally paid more attention to getting the money than to the sensibilities or troubles of beleaguered debtors. However, changes are underway and many major creditors are taking new approaches to collection procedures. Many have concluded that traditional practices sacrifice good will and may not even achieve maximum repayment at minimum cost.

II. What Ethical Creditors Can Do

The Committee on Creditor Remedies and Collection Practices was assigned the task of examining the issues and of developing a code of ethical practices to which creditors could subscribe. We believe the recommended code, appearing later in this report, will substantially reduce the number of legitimate customer complaints. We think it will increase the number of debts recovered without legal action and may also reduce collection costs. This supposition is not merely theoretical. One major creditor who has adopted practices similar to those we recommend has experienced a reduction in customer disputes and complaints and an increase in repayments after exercising greater sensitivity in written communications and personal contacts. The additional expense required to establish better communications with debtors has resulted in reduced costs at later stages in the collection process.

To deal with unscrupulous creditors, some additional legal protections may be necessary. However, the most effective way to reduce large numbers of consumers who depend on such sources is to maintain ready availability of credit from ethical suppliers of credit. Accordingly, we trust that the U.S. Congress and State legislatures will not impose legal restrictions that will make it difficult for ethical creditors to operate profitably and force them, as a result, to deny credit to many individuals whom they now serve.

III. Credit Policy and Collection Expenses

To understand why we make this point, it is necessary to explain something about the profit and loss structure of the consumer credit business. Some grantors of credit are basically merchandisers, using credit as a sales tool. Banks and consumer finance companies make their profits primarily on the sale of credit. In either case, however, repayment of the debt is fundamental to the creditor's profit or loss picture.

Generally speaking, creditors, whether merchandisers or consumer lenders, have ways to optimize earnings. One is to go for high volume, accepting a relatively high number of delinquent debts and absorbing resulting collection costs. The other is extending credit only to individuals with stable employment backgrounds whose repayment record is well established.

If the creditor follows the credit restriction route, he must refuse many so called "marginal" borrowers who, in practice, may be good credit risks. One major creditor estimates that he could reduce defaulted loans 40 percent by increasing his rejection rate to 25 percent from 15 percent. But instead of 56,000 credit applicants, he would have had to reject 93,000 in 1971. Most of those rejected would have been at the lower end of the economic scale.

Some would applaud this, for there are critics who incorrectly claim that the credit industry "foists unwanted credit on the poor". This charge has no validity. Spokesmen for the poor have repeatedly demanded *easier* access to credit from ethical creditors for experience shows that upon refusal, the poor resort to any source of credit, catch-as-catch-can, paying exorbitant rates and mortgaging their income at levels no law would permit.

Another unavoidable fact is that service to lower income patrons carries additional risks for the creditor. The most significant costs associated with such service are the expenses of debt collection and bad-debt write-offs. They comprise the largest cost for a consumer credit organization (except for the cost of funds). In many instances they amount to more than half of the organization's operating costs. In the case of consumer loans, it is estimated that it takes approximately 10 good loans to cover the expenses of one bad loan.

IV. The Delinquent Debtor

The $120 billion in consumer debts outstanding may be visualized as an inverted triangle, divided into two segments. The small bottom segment, those in serious stages of default,

represents approximately 2 percent of the total, or $2.4 billion indebtedness, and 4.4 million accounts. The top segment comprises 98 percent of the total, or $118 billion indebtedness and about 170 million accounts.

Many of the 98 percent will never receive a late payment notice. Others will—perhaps because the bill was mislaid or because of mail delays or vacations or other temporary absences from home. Perhaps the customer is disputing a bill he believes to be in error, or he is temporarily short of funds to meet his monthly financial obligations.

Consumer annoyance is usually generated by initial late notices that are unnecessarily harsh in tone, or by second notices that allow the customer no time to respond to his first notice. Well-intentioned debtors normally do not mind a gentle reminder, but they resent preemptory demands for payment, especially if accompanied by warnings that failure to pay IMMEDIATELY may lead to loss of good credit standing or worse. Until very recently, many creditors thoughtlessly offended customers through such communications. Some still do, losing good will in the process and sometimes the customer.

Among the two percent in serious default, most are in difficulty because their anticipated income has been reduced. Some may have lost jobs or become ill, or a family emergency may have caused a sudden increase in expenses or mismanagement of family budget. Credit overloading is not a significant factor. Good business practice requires that credit should not be given beyond the customer's ability to repay. Deliberate overloading is an open invitation to higher losses and collection costs.

The debtor who wants to pay but can't temporarily, can frequently solve his financial problems within the credit system itself. Most creditors, if they know the facts surrounding a customer's problems and are convinced of his good will and intent to pay, usually are understanding and willing to help. They may defer payments or refinance the debt to reduce the size of the monthly payments. It may be possible to return merchandise bought on time before repossession is necessary. But it is important to go to creditors before payments are overdue, or as soon as possible thereafter, to see what arrangements can be made for fulfilling obligations. The worst thing a debtor can do if he is not able to meet payments on schedule is avoid his creditors.

Creditors must also deal, however, with cases—small in percentages but large in numbers and dollars—where the

debtor has simply decided for one reason or another that he will no longer honor the debt. Even then, the debtor sometimes has a complaint, real or imaginary, that may be capable of settlement if communication channels are kept open. Unfortunately, there remains a residue of debts requiring more stringent collection methods, including, finally, resort to remedies available under the credit contract or to the courts.

V. The Collection Process

The early stages of the collection process do not usually affect serious default cases, but they should be described for the sake of completeness. The first step, obviously, is the customer's bill. In the case of closed-end credits, such as level payment accounts, the bill may take the form of a coupon book specifying the amounts due and when. Open-end credits, such as department store charge accounts, charge cards and check credit mechanisms bring a monthly bill indicating, among other things, the customer's new balance, the minimum payment due, the finance charge, the annual percentage rate, and the date, if any, by which payment must be received to avoid a service charge.

The next stage is the sending out of late notices or reminders. While creditors have different patterns, the first such reminder may be mailed 5 to 30 days after the bill is due for payment. If delinquency continues, additional notices (sometimes letters) will be sent urging prompt payment and generally graduating in the seriousness depending upon the extent of delinquency. Of the 98 percent in the upper part of the triangle, all but a handful will normally pay long before the advanced stage of written communications is reached.

When notices and letters fail to bring results, personal contact, normally by telephone, follows. Most creditors do not initiate telephone collection until the account is at least one full month or more overdue. In the wrong hands, telephone contact is susceptible to abuse. In the hands of an ethical creditor, however, this tool gives an opportunity to learn the cause of the delinquency and to encourage the debtor to make partial payment or take other steps to cure the default. Collectors will also explain the remedies and penalties that may be invoked if the debtor fails to take any action.

Relatively few consumers are ever contacted by telephone collectors. But approximately 2.2 million accounts totaling $1.2 billion—roughly one-half of all delinquent accounts—are restored to current status by this procedure.

For the remaining one-half of delinquent debtors who fail to respond or who break promises to resume payment, more serious actions are required. Depending on circumstances, these actions may be initiated 45 to 90 days after payment is initially due. To bring the situation to a head and to protect his position, the creditor may resort to remedies allowed under the original contract—repossession of merchandise, attachment of wages, off-sets against deposit accounts, and the like. Use of contractual remedies (or informing delinquent customers of the creditor's recourse) is estimated to account for recovery of $240 million on 350,000 delinquent accounts.

If contractual remedies are insufficient, and if it appears to the creditor that the debtor has sufficient assets to make a judgment collectible, the creditor usually initiates court action also. The debtor must receive a copy of the complaint and service of summons, setting forth the time and place for trial. Though aware of their right to defend against the creditor's claims, only a small number of debtors appear in court resulting in a default judgment in the creditor's favor. Such judgments substantially extend the statute of limitations for collection of the debt and also open up other remedies to the creditor. A percentage of the debtor's earnings may be dedicated by court order for satisfaction of the debt. (In most jurisdictions, only one creditor at a time can avail himself of this remedy.) Debtors may be required to appear under oath and testify regarding their property. Liens may then be placed against real property. In some areas, a favorable judgment entitles the creditor to have property such as automobiles and assets such as bank accounts seized by a marshall or sheriff and liquidated to satisfy the debt. It is extremely rare that a debtor's true circumstances provide a legal basis for nonpayment. Contested cases are uncommon, and they are almost always won by the creditor. The total amount recovered as a result of legal processes is not currently known.*

An estimated $960 million in consumer debt is written off annually as uncollectable. Together with expenses incurred in successful recovery of delinquent debts, bad debts are a significant element in determining finance charges which creditors must impose, not only on the two percent at

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* With the aid of the Census Bureau, the National Commission on Consumer Finance is collecting data on this and other questions where little or no information is currently available.

the bottom of the credit triangle, but also on the 98 percent who pay up without difficulty.

VI. Debtor Grievances

As previously pointed out, the early stages of the collection process often generate unnecessary friction. Billing errors frequently cause disputes. Another source of complaint about open-end credits is the allegation that some creditors try to increase finance charges by delaying bills so that they arrive near the end of the grace period after bills are issued, during which no finance charge applies, provided the customer pays the bill in full. While no ethical creditor would engage in such a practice, time is needed to prepare and mail the monthly billing. If there is an equipment failure, for example, delays can easily mount. In open-end credit arrangements, the grace period begins on the day that the books are closed for the preceding month and usually lasts for 25 days or more. Major creditors consulted in connection with this study estimate that their bills normally go into the mail between 5 and 14 days after the books are closed. This should normally provide the customer with enough time to receive and pay the bill without incurring finance charges.

Later stages of the collection process cause the most vigorous (though not the most numerous) complaints. Common accusations at the personal contact stage include invasion of privacy through telephone calls made at unreasonable hours, use of abusive and threatening language by telephone collectors, and harassment by creditors who get in touch with employers to apply pressure for payment, which is sometimes alleged to cost debtors their jobs.

Resort to remedies available under the credit contract, such as repossession or wage assignment, are frequently attacked as denying the debtor his day in court. The accusation is made that repossession of chattels often results in sale of the goods at less than full value, with the creditor counting on a deficiency judgment to recover the balance. A further source of consumer grievances is the Holder-in-Due-Course doctrine. This body of commercial law says that a purchaser who buys goods from, for example, a retailer, cannot refuse to pay a credit firm that acquires the purchaser's debt obligation because of dissatisfaction with the merchandise or with the seller's service. In other words, a shoddy home improvement job, a television set that immediately goes

on the blink, or an automobile that is a lemon furnishes no legal basis for withholding installment payments to the lender who purchased the retailer's paper.

While creditors stand accused of depriving debtors of their day in court, they are also frequently charged with excessive reliance on a judicial system. In New York City, special difficulty is presented by an antiquated process serving system said to result all too frequently in "sewer service"—i.e., in false affidavits that summonses were personally served when they actually were discarded by process servers working on commission.

An underlying complaint, common to many stages of the collection process, is the contention that disclosure of the terms of the debt is often inadequate and that the obligations and rights of the debtor are rarely explained to him in plain language.

VII. A Code for Ethical Credit Grantors

The Committee has concluded that many of the complaints summarized above have at least some basis in fact. It believes that legitimate complaints can be eliminated by ethical creditors who will adhere to the code of collection standards which this Committee has attempted to formulate. Those standards assume that most debt problems arise through circumstances beyond the control of the customer. Ethical creditors should be willing to work with persons who desire to pay. Collection practices should not offend the dignity of the customer nor trespass on his feelings as a human being.

Legislation, although not necessarily a solution to questionable collection practices, may be helpful in certain respects. For example, the Committee suggests there may be merit in creation of consumer credit claims courts with simpler and more effective procedures for assuring notification of delinquent debtors, such as service by registered mail. Such a court could give consumers their day in court and provide a mechanism for arbitrating creditor-debtor disputes.

We are inclined to believe that creditors who fail to adhere to a well-advertised ethical collection code will suffer in the marketplace.

Here then is the code recommended by the Committee:

- 1. Creditors should fully explain to their customers the terms of any loan or credit arrangement and should also make clear the repayment obligations which the customer is undertaking. The explanation

should be clearly and concisely stated in understandable terminology. It should be provided in writing and, if possible, orally—with the advice that the customer also read the contract before signing. Disclosure should be made also to any co-makers or co-signers of the contract.

- 2. Creditors should dispatch bills to customers as soon as possible after the billing cycle ends. The date by which full payment must be received before a finance charge is levied should be clearly indicated. Bills should be mailed at least two weeks or earlier before payment is required to avoid a finance charge, preferably earlier. In event that equipment failure or administrative problems prevent bills from going out in time, a notice extending the grace period should accompany the bill.
- 3. Calls or correspondence from a customer claiming an error in billing should be acknowledged as promptly as possible—in no case later than 30 days after the complaint is received. An investigation should be made and if the complaint is valid, the customer's account should be corrected as rapidly as possible—in no case later than 90 days after the error was called to the creditor's attention. If an investigation reveals that the billing is correct, the customer should be immediately notified of the fact, preferably by personal letter, with documentation supplied.
- 4. Consumer credit collection practices should be based on the presumption that every debtor intends to repay or would repay if able. Until events establish that the customer is evading payment, all communications, whether in writing or by telephone, should be based on this presumption. Preliminary late notices should merely remind the customer that payment is overdue and should recognize the possibility that payment may cross in the mail. Subsequent notices should continue to be polite, inviting the customer to call or write if there are any problems about payment or disagreements about billing. Including the name and telephone number of a person the customer can contact should be considered if the creditor's manpower resources permit. If not, a contact unit and telephone number should be specified.

- 5. Debtors who show a sincere desire to repay their debt should be encouraged to refinance, consolidate, make reduced payments or make other arrangements that will help the debtor re-establish himself. Contractual remedies or litigation should be undertaken only as a last resort. Where circumstances indicate that such remedies will be futile because the debtor lacks assets or income to satisfy the debt, legal remedies should not be pursued blindly or vindictively.
- 6. Late charges should be assessed only to the extent necessary to recover additional expenses caused by the delinquency. Partial or full forgiveness of such charges should be considered where warranted.
- 7. Telephone collectors should be taught to determine the cause of delinquency and indicate their willingness to arrange a mutually satisfactory repayment schedule.
- 8. If the customer does not respond to an offer to help make alternative arrangements, the collector should explain the seriousness of continuing delinquency and advise the debtor of the courses of action open under the contract and under the law. Personal abuse, harassment, threats and other unconscionable tactics should be forbidden. Legal action should not be taken unless it has been decided that this is the only course of action left.
- 9. Telephone contacts should not be made before 8:00 a.m. or after 8.00 p.m., unless other times are more convenient for the customer. If a collector finds it necessary to call at the debtor's place of business and does not locate the debtor, he should merely identify himself and leave a return number, indicating the urgency of a response.
- 10. Collectors should understand that they are dealing with individuals about highly personal matters and that most delinquencies arise through circumstances beyond the debtor's control.
- 11. Where creditors employ outside agencies to collect delinquent accounts, they should furnish these agencies with written instructions clearly spelling out how borrowers are to be approached, what practices are sanctioned, and which are not. Creditors should monitor the collection activities of their own staffs as well as their collection agencies.

- 12. Attorneys, process servers, and other agents representing the creditor in legal capacity should be advised of the standards of service expected of them. In addition, creditors should assume an obligation to monitor their activities to assure that high ethical standards are being maintained. Complaints of improper activity should be investigated, and if found true, the agent or agency involved should be held accountable. Serious or repeated offenses should be grounds for dismissal, or change in agency used.
- 13. Creditors should be particularly careful in handling delinquencies due to a debtor's dissatisfaction with the goods or services financed. Complaints regarding the quality of goods or services should be referred to the dealer immediately, requesting that the problem be resolved or an explanation given promptly. Creditors should ask the customer to pay off the portion of the debt not in dispute but should not press for payment of the disputed portion until the dealer's position has been determined and the customer has been notified of the result. Corporations purchasing merchants' contracts should set up procedures to review their association with merchants, and should be prepared to require them to endeavor to satisfactorily resolve complaints, to repurchase the contracts of customers who have legitimate unresolved complaints and in the event of numerous complaints or unethical merchant practices, refuse to do further business with the merchants involved.
- 14. Customer complaints concerning his account or collection practices should be investigated immediately. Until the facts have been determined, creditors should assume that the customer's complaints are legitimate. Complaints should be used as a training aid in addition to providing management an insight into their collection departments performance standards.

VIII. Limiting Factors

Before ending, the Committee wishes to take note of certain limiting factors that must be considered in modifying the collections process.

As previously pointed out, telephone collection performs an essential function in recovery of delinquent debts. Creditors must be free, while maintaining standards of perform-

ance such as those set forth in the code, to communicate by telephone with delinquent customers. Creditors should refrain from trying to bring pressure on a debtor through his employer, but they should be entitled to call a debtor's place of work and request a return call. Creditors must likewise retain the right to inform co-makers and endorsers of the extent of the delinquency and of the remedies and penalties which may apply to them if the delinquency continues.

Unrealistic attempts to limit repossession and sale of merchandise could also have an adverse effect on credit costs. To the creditor, repossessed chattels constitute distress merchandise. The retail price is not an appropriate measure of value. Retail sales prices encompass commissions, overhead, and other expenses which the creditor, in effect, must purchase by selling the repossessed merchandise at a discount. If he himself is a retailer, the creditor must take into account these same expenses as part of the cost of a "second sale" of the repossessed merchandise. The expenses of this second sale arise from the repossession and should be charged to the defaulting borrower.

Also, as the code suggests, creditors have an obligation to maintain closer scrutiny over the practice of dealers whose paper they purchase, but manufacturers must also assume greater and more willing responsibility for their products and for their dealers' activities. In the end, it is the manufacturer and the seller of shoddy merchandise who should bear the burden of repair or replacement, not the customer and not an institution which simply finances the transaction. Placing this burden where it belongs avoids the unjust tarring of the reputable and responsible financial institutions, and perhaps more importantly, it provides the proper remedy and protection to the cash customer as well as the credit customer. Many of the current proposals would leave the cash customer high and dry—surely he should have the same remedies for exactly the same problems.

IX. Concluding Comment

The Committee strongly believes that improvement of communications between consumers and creditors will reduce the number of consumer problems, possibly even reducing overall collection costs, provided that reasonable creditor remedies are retained. Since collection costs directly affect the price of consumer credit to *all* borrowers, improvements should benefit all who handle their credit properly in addition to removing serious irritants from the existing system.

The most reliable source of data on consumer credit outstandings is the Federal Reserve System. It publishes monthly bulletins recording consumer outstandings in dollars. Delinquency ratios are collected by the Federal Reserve from data which lenders are required to provide, as well as by numerous organizations such as the American Bankers Association. Applying these ratios to outstanding consumer debt as reported by the Federal Reserve category by category, one can obtain a reasonably good gauge of the outstanding dollars of credit in default. Delinquency ratios vary by product line but on the average about 2 percent of outstanding consumer credit is delinquent 30 days or more. What is not clear from such data is the number of delinquent accounts existing nationally and the number of debtors holding these accounts.

The most prestigious data collections currently available are those provided by the University of Michigan's Survey Research Center. These conclude that about half the families in the United States utilize consumer credit at any given point in time. This suggests that there are some 33 million borrowing families and that, at a 2 percent delinquency rate, only 660,000 become affected by any collection activity apart from routine late notices.

Other information, however, suggests that the number of debtors may be higher than estimated in the University of

Michigan study. The ABA compiles average dollar balances outstanding on loans in various categories reported by the Federal Reserve. Dividing these average balances into total dollars outstanding in each category provides an estimate on the number of outstanding accounts. Table I provides such an estimate.

Consumer credit outstandings in Table I are as of June 30, 1971, as reported in the February 1972 issue of the Federal Reserve Bulletin. Average loan size was taken from figures reported by the American Bankers Association. In the category of automobile loans, it was assumed that experiences of non-bank lenders paralleled bank indirect results. Accordingly, average size loan and delinquency ratios pertinent to the indirect category were applied.

In the "Other" category, the division between mobile home and appliance outstandings, which comprised the Federal Reserve total, were deducted as follows: The number of mobile home occupants was obtained from the 1970 Census Report, and it was assumed that each occupant was financing his home. The average mobile home loan outstandings was multiplied by the number of mobile home occupants. This dollar figure was subtracted from the total "Other" category to determine the dollars in the appliance loan category.

In analyzing non-installment credit, some $10 million of single payment loans were disregarded. Charge card outstandings in dollars were derived from data in the report, "Growth & Profitability of Credit Card Banking," made by Andrew F. Brimmer, Member of the Board of Governors of the Federal Reserve System at the 1971 National Credit Card Conference of the American Bankers Association. From the testimony given by the ABA and others before Senate Subcommittee on Financial Institutions, October 29, 1971, the number of bank monthly billings was determined and by comparing bank shares of outstandings to the others in this category, the number of billings of non-bank revolving credit accounts was derived. Bank delinquency figures were applied to both categories.

The latest available bank check credit figures were derived from 1968 outstandings in the Brimmer Report and bank delinquency figures were applied to the active account population only.

Assumed in these calculations, of course, are the accuracy of ABA loan size estimates and delinquency ratios and their applicability to non-bank credit grantors.

Table I

	Aver. Loan (ABA data)	Total Outstanding FRB Data in $ Billions	Total Accounts Estimated in Millions	Total Delinquency Ratios	Total Delinquent Accounts in Thousands
Personal Loan	$813	$32.35	39.79		780
Bank		10.84	13.33	1.96	261
Other		21.51	26.46	1.96	519
Auto		36.35	26.78		345
Bank					
Direct	1519	8.10	5.33	2.14	114
Indirect	1317	12.48	9.48	1.08	102
Other	1317	15.77	11.97	1.08	129
Home Modernization		4.19	2.72		38
Bank		2.77	1.73	1.37	24
Direct	1774				
Indirect	1433				
Other	1433	1.42	.99	1.37	14
Other Consumer		28.99	34.18		707
Bank		8.82	7.29		
Mobile Homes	5250	2.91	.55	1.53	8
Appliances		5.91	6.74	2.10	142
Direct	1224				
Indirect	529				
Other		20.17	26.89		
Mobile Homes	5250	6.61	1.26	1.53	19
Appliances	529	13.56	25.63	2.10	538
Installment Credit Totals		**101.88**	**103.47**		**1,869**
Non-Installment Credit					
Total open-end credit		16.90	70.20		
Check credit		1.40	.80		
		18.30	71.00	3.6	2,556
Final Totals		**$120.18**	**174.47**		**4,425**

See Text of Appendix I for explanation of methodology used in deriving figures.

Table II applies delinquency ratios to the estimated number of accounts. In the home improvement category, delinquency ratios were obtained by averaging ABA, FHA and Home Modernization loan categories as follows:

Delinquency Category	(Percent of All Borrowers) FHA	Property Improvement	Average Rate
30-59 Days	1.16	.99	1.07
60-89 Days	.34	.24	.29
90 & Over	.61	.14	.37
TOTAL	2.11	1.37	1.73

To summarize the tabulation in Tables I and II, it is estimated that approximately 174.47 million accounts are outstanding, of which 4.43 million are 30 days or more delinquent. Of these, 2.5 million are delinquent 30 to 59 days, 0.87 million are delinquent 60 to 89 days and 1.02 million are delinquent 90 days or over.

Table II

	ABA Delinquency Ratios				Total Delinquent Accts.			
	30-59 days	60-89	90	Total	30-59 days	60-89	90	Total
	(percent of all borrowers)				(Thousands)			
Personal Loan								
Bank	1.16	.40	.40	1.96	155	53	53	261
Other	1.16	.40	.40	1.96	307	106	106	519
Auto								
Bank: Direct	1.34	.37	.43	2.14	71	20	23	114
Indirect	.74	.20	.14	1.08	70	19	13	102
Other	.74	.20	.14	1.08	88	24	17	129
Home Modernization								
Bank:	.99	.24	.14	1.37	17	4	3	24
Other:	.99	.24	.14	1.37	10	2	1	13
Other Consumer								
Bank: mobiles	.98	.31	.24	1.53	5	2	1	8
appliances	1.38	.43	.29	2.10	93	29	20	142
Other: mobiles	.98	.31	.24	1.53	12	4	3	19
appliances	1.38	.43	.29	2.10	354	110	74	538
Instalment Credit Totals					**1,182**	**373**	**314**	**1,869**
Bank-open Credit	1.9	.7	—	3.6	308	113	162	583
Other open-end credit	1.9	.7	—	3.6	1,026	378	540	1,944
Total open-end credit	1.9	.7	—	3.6	1,334	491	702	2,527
Check Credit	1.9	.7	—	3.6	15	6	8	29
Non-installment credit totals					**1,349**	**497**	**710**	**2,556**
Final Totals					**2,531**	**870**	**1,024**	**4,425**

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National Business Council for Consumer Affairs

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